87-2026

No. ____________

In the Supreme Court
of the United States

OCTOBER TERM, 1987

JAMES E. SOCHIN,
Petitioner,
vs.
COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH JUDICIAL CIRCUIT

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QUESTION PRESENTED

There is only one question presented: In controversies involving the application of the federal income tax laws (and specifically in this case, the application of section 108 of Pub. L. No. 98-369, 98 Stat. 494, 630 (Deficit Reduction Act of 1984) and the application of 26 USC 165(c)(2) (Internal Revenue Code of 1986, as amended) to the income tax effects upon an investor in commodity straddle transactions), where the Internal Revenue Service alleges that the transactions are shams, not to be recognized for tax purposes, is the legal standard to be applied to the evidence to determine whether or not the transactions are shams, the clear, two-part test of *Rice's Toyota World, Inc. v. Commissioner*, 752 F.2d 89, 55 AFTR2d 580 (4th Cir. 1985), or the more amorphous, *ad hoc* test applied by the United States Court of Appeals for the Ninth Circuit in this case, *Sochin v. Commissioner*, 9th Cir. dkt. no. 87-7024, 843 F.2d 351, 61 AFTR2d 926 (¶ 88-453) (9th Cir. 1988)?

In *Rice's Toyota*, The United States Court of Appeals for the Fourth Circuit held that a transaction is a sham for tax purposes *only if* the evidence shows that *both* of two conditions are met: (1) that the taxpayer was motivated by *no* business purpose other than the obtaining of a tax benefit; *and* (2) that the transaction had no reasonable possibility for non-tax profit. *Rice's Toyota World, Inc. v. Commissioner*, 752 F.2d 89, 55 AFTR2d 580, 585 (4th Cir. 1985).

The United States Court of Appeals for the Second Circuit, and also the United States Claims Court, apply this clear, two-part test. *United States v. Philatelic Leasing, Ltd.*, 794 F.2d 781, 58 AFTR2d 5285, 5289 (2nd Cir. 1986); *Johnson v. United States*, 11 Cl. Ct. 17, 58 AFTR2d 5894, 5900 (Cl. Ct. 1986).

In the instant case, the United States Court of Appeals for the Ninth Circuit rejected that test and adopted an *ad hoc* "practical economic effects" test instead. *Sochin v. Commissioner*, slip opinion at p. A-7.

This creates a conflict in the lower federal courts, including the circuit courts of appeal, over this important question in the administration of the federal income tax laws.

LISTING OF PARTIES

The listing of the parties in the court the judgment of which is sought to be reviewed (United States Court of Appeals for the Ninth Circuit) are as follows:

- James E. Sochin, an individual of San Francisco, California, petitioner here, and petitioner-appellant in the court of appeals;

- Dennis S. Brown, an individual of Portland, Oregon who is *not* a petitioner here, but was a petitioner-appellant in the court of appeals; and

- The Commissioner of Internal Revenue, respondent here and respondent-appellee in the court of appeals.

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TABLE OF AUTHORITIES

CITATION TO CASE OPINIONS

Sochin v. Commissioner (sub nom Brown v. Commissioner), tax court docket no. 2313-83, opinion published at 85 T.C. 968 (1985), and reproduced in the appendix to this petition.

Sochin v. Commissioner, ninth circuit docket no. 87-7024, 843 F.2d 351, 61 AFTR2d 926 (§ 88-453)(9th Cir. 1988), and reproduced in the appendix to this petition.

STATEMENT OF GROUNDS FOR SUPREME COURT JURISDICTION

The date of the ninth circuit's judgment and opinion is March 29, 1988, and the opinion was filed by the court on the same day, March 29, 1988. By order dated April 19, 1988, the court of appeals' mandate has been stayed pending this petition to the Supreme Court.

There have been no petitions for rehearing filed with the court of appeals.

There have been no requests for, or orders granting, an extension of time within which to file this petition for writ of certiorari.

Sections 1 and 2 of Article III, of the United States Constitution grant the Supreme Court appellate jurisdiction in cases arising under the laws of the United States. This case arises under the federal income tax laws.

Moreover, 26 USC 7482(a)(1) specifically authorizes Supreme Court review of the judgment of a court of appeals that has reviewed a decision of the United States Tax Court, as here. The review is authorized "in the manner provided in" 28 USC 1254 (petition for writ of certiorari).

STATUTORY PROVISIONS

This case involves a conflict in the circuit courts of appeal and other lower federal courts over the court-enunciated rules to be applied to measure the evidence of record in cases in which the respondent, Commissioner of Internal Revenue, contends that a transaction should not be recognized for tax purposes because it is alleged to be a "sham." Therefore, no specific reference to a statutory provision needs to be made to determine the correct rule.

However, although not directly involved in deciding the question presented, the underlying statutory rules that govern the taxation of the commodity straddle investments made in this case are two:

> (i) section 108 of Pub. L. No. 98-369, 98 Stat. 494, 630-631 (Deficit Reduction Act of 1984) as amended by sections 2 and 1808(d) of Pub. L. No. 99-514, 100 Stat. 2085, 2095, 2817-2818 (Tax Reform Act of 1986), with effective dates of amendments as if originally included in Pub. L. No. 98-369 (July 18, 1984) (see secs. 2(b)(1) and 1881 of Pub. L. No. 99-514, 100 Stat. at 2095 and 2914); and
>
> (ii) 26 USC 165(c)(2), *Internal Revenue Code of 1986*, as amended.

The text of both of those laws is set out in the appendix to this petition.

STATEMENT OF THE CASE

This petition involves an appeal by James E. Sochin of a determination of federal income tax deficiencies for 1979, 1980, and 1981 by the Commissioner of Internal Revenue in a statutory notice of deficiency issued by the commissioner under 26 USC 6212. Mr. Sochin filed a timely appeal with the United States Tax Court, which had jurisdiction to hear the matter under 26 USC 6213(a) and 7442. Mr. Sochin's timely notice of appeal from an adverse tax court decision entered on December 30, 1986, conferred jurisdiction on the court of appeals under 26 USC 7482(a) and 7483.

During the 1970's and the early 1980's many investment firms offered customers an investment in commodity straddles or financial instrument straddles. The firms offering these investments ranged from the large, publicly-owned houses, like Merrill, Lynch, Pierce, Fenner & Smith, Inc., to small privately held firms, such as Gregory Government Securities, Inc., of Portland, Oregon, from which the petitioner bought his investment in this case. Straddle investments were designed as a simultaneous purchase and sale of the same or a similar item at a stated price. Delivery dates under the arrangement were set for a future time, which was usually one date for the purchase and a different date for the sale. Market forces acting upon the forward or futures contracts in the straddle would cause one contract to lose value while its companion contract would gain in value. The straddles were supposed to be constructed in such a way that the contract gains would exceed the contract losses, thus allowing for a potential overall profit from a particular straddle.

In this case Mr. Sochin made an overall profit (after payment of all transaction fees) on his 1979 straddle, but had overall losses on his 1980 and 1981 straddles.

The straddles involved in this case were forward contracts between Mr. Sochin (and his investment group) on the one hand and the offering company, Gregory Government Securities, Inc., on the other hand. The forward contracts were for delivery of Ginnie Mae mortgage certificates or Freddie Mac mortgage certificates. (Ginnie Mae is the Government National Mortgage Association, a wholly-owned government corporation under the United States Department of Housing and Urban Development; Freddie Mac is the Federal Home Loan Mortgage Corporation, the capital stock of which is owned by the Federal Home Loan Bank).

Forward or futures contracts are frequently used as speculative investments which are closed between the parties for cash profit or loss before the delivery date arrives.

Gregory Government Securitites, Inc., the dealer here, was a registered broker-dealer with the Securities Division of the Oregon Department of Commerce and was actively regulated by that division during the period in question (1979-1981).

In 1979 petitioner James Sochin (through an investment group with his fellow employees called Harsh Associates) purchased a straddle from Gregory Government Securities, Inc. After making an overall profit in the 1979 straddle (getting a return of $2,461 on $2000 invested) Mr. Sochin invested again in 1980 and 1981.

The closing of the various contracts within each straddle produced both gains and losses. Mr. Sochin deducted the losses as ordinary losses on the federal income tax return for each year the losses were incurred (1979, 1980, and 1981). In each case the gains incurred in the straddle were also duly reported in the appropriate year and Mr. Sochin paid the tax imposed with respect to those gains.

Gains and losses were reported on Mr. Sochin's federal income tax returns as follows:

Loss		*Net Gain*	
1979	[$20,621]	1980	$21,142
1980	[$48,054]	1982	$44,804
1981	[$38,785]	1983	$35,756

In reporting ordinary losses and long term capital gains in the manner set forth above, Mr. Sochin secured substantial tax savings (in addition to his trading profits for 1979). The Internal Revenue Service took exception to the tax savings, and asserted income tax deficiencies against Mr. Sochin by disallowing the deductions for the losses incurred.

Without detailing the evidence here, it is an accurate reflection of the evidence of record to say:

> (i) that Mr. Sochin and his fellow investors in Harsh Associates carefully investigated the investment before investing;

(ii) that Mr. Sochin met personally with William Gregory of Gregory Government Securities, Inc., and demanded of him more details on exactly how profits were to be made from the investment;

(iii) that Harsh Associates carefully monitored the investment as long as the contracts remained open;

(iv) that the hedging practices of Gregory Government Securities, Inc., with respect to the forward contracts were imposed by and monitored by the Oregon Securities Division;

(v) that the pricing of the contracts involved here was done by the use of a commercially reasonable formula similar to the formula used by the Federal Home Loan Bank of Indianapolis, Indiana; and

(vi) that Mr. Sochin made a profit on his 1979 straddle even after payment of all transaction fees.

Accordingly, if the clear, two-part test for profit intent and economic substance used by the second and fourth circuits, as well as by the claims court, had been applied here, Mr. Sochin's income tax deductions would not have been disallowed, at least not on the ground of "sham," as they were by both the tax court and the ninth circuit. But by using an amorphous, standardless, *ad hoc* test, both the tax court and the ninth circuit were able to avoid coming to grips with the evidence of record relating specifically to Mr. Sochin and his particular investment, and each court thus also avoided application of the statutory rules enacted by Congress for the investment.

ARGUMENT

This case presents a conflict in the circuit courts of appeal. The question presented is whether the federal courts in responding to an attack by the Commissioner of Internal Revenue on an investment as a "sham" should measure the evidence of record according to the predictable and clear two-part test used by the second and fourth circuits as well as by the United States Claims Court, or whether the *ad hoc* approach used by the ninth circuit is correct. The Supreme Court last addressed the question of economic substance for tax purposes in *Frank Lyon & Company v. United States*, 435 U.S. 561, 55 L.Ed.2d 550, 98 S.Ct. 1291, 41 AFTR2d 1142 (1978), and in *Commissioner v. Bollinger*, 485 U.S. _____, 99 L.Ed.2d 357, 108 S.Ct. _____, 61 AFTR2d 793 (1988); but both of those cases involved an ordinary commercial context, not a speculative investment, and both involved the shaping of a transaction under the exigencies of state law regulatory requirements (banking or usury laws) rather than investments specifically designed for both profit and tax benefits. Since the lower federal courts are sharply divided over the legal standards to be applied to investments which are argued by the taxpayers to be partially tax motivated but nonetheless well within the law, and since there are hundreds of such cases pending, the instant case would be an appropriate opportunity for the Supreme Court to further extend or clarify the standards in *Frank Lyon* and *Bollinger* to the class of cases described above and presented by the facts in this record.

The issue to be decided is clearly presented by the circumstances of this case.

First, the ninth circuit in its opinion explicitly rejected the approach used by both the second and fourth circuits (as well as by the claims court).

Second, Congress has enacted specific legislation to allow straddle losses as deductions for income tax purposes, but, to avoid the application of that law, the Commissioner of Internal Revenue has argued that the law need not be applied in cases in which it is determined that the investment was a sham. *Compare Wehrly v. United States*, 808 F.2d 1311, 58 AFTR2d 5260 (9th Cir. 1986) (deduction for straddle losses allowed under special legislation if the straddle transaction had a reasonable prospect of a profit), *with Sochin v. Commissioner*, 843 F.2d 351, 61 AFTR2d 926 (9th Cir. 1988) (special legislation does

not apply if transaction was a sham). Of course, the Commissioner's approach is correct in the sense that *if* a transaction really did not exist, or *if* a transaction was designed *solely* for tax purposes and had *no* potential for profit beyond tax savings, then the transaction should not be recognized for tax purposes and there is no use arguing over the statutory rules to be applied. But that is the big "if" involved in this and similar cases. Is a federal court authorized to declare a transaction a "sham" and thus avoid the harder questions involved in a precise application of statutory language to the evidence of record relating to the taxpayer's motives and to the true economic potential of the investment? Or is a federal court, rather, required to apply a clearly stated legal standard to the evidence so that the statutory rules enacted by Congress can be brought into play? Thus the legal standard for measuring evidence on the sham issue has a concrete application to this case and the result of the case on that issue will differ depending on which approach is used. Therefore, this case presents an ideal vehicle for clarification of the tax law on this point.

The tax court and the ninth circuit in this case used an *ad hoc*, "I-know-it-when-I-see-it" approach to the determination of sham, *vel non*. That approach has three detrimental effects: (a) tax planning becomes far less certain; (b) without clear guidance from the courts as to what the legal standard for tax purposes is, more (and perhaps undesirable) experimentation by taxpayers and their counsel is encouraged; and (c) far fewer cases clogging the lower courts will be settled if the litigants on both sides believe they can make particularized arguments to the court based on factors involved in their case without reference to a clear, stated legal standard and without reference to precedent. In short, if every case is unique and if every case will be decided by the judge without reference to stated legal standards, then experimentation will be encouraged, but settlement of tax litigation arising out of that experimentation will be discouraged.

Finally, the lower federal courts are divided on their approach to this issue and guidance for uniformity is desirable.

The rule in the fourth and second circuits is this: a transaction is a sham for tax purposes *only if:*

> (i) the taxpayer was motivated by *no* business purpose other than obtaining tax benefits in entering into the transaction, *and*

(ii) the transaction has no economic substance *because* no reasonable possibility of a profit exists.

Rice's Toyota World, Inc. v. Commissioner, 752 F.2d 89, 55 AFTR2d 580, at 585 (4th Cir. 1985); *United States v. Philatelic Leasing, Ltd.*, 794 F.2d 781, 58 AFTR2d 5285 at 5289 (2nd Cir.. 1986).

The United States Claims Court also follows that rule.

> "Over the years the sham inquiry has been refined. Recently *Rice's Toyota World, Inc. v. Commissioner*,752 F.2d 89, 91 (4th Cir. 1985), articulated a precise test. 'To treat a transaction as a sham, the court must find that the taxpayer was motivated by no business purposes other than obtaining tax benefits in entering into the transaction, and that the transaction has no economic substance because no reasonable possibility of a profit exists. . . .' As can be seen, this requires a subjective business purpose *or* an objective possibility of profit. *This precision is desirable*, and does not conflict with *Rothschild [v. United States*, 186 Ct.Cl. 709, 407 F.2d 404, 23 AFTR2d 637 (Ct.Cl. 1969)]; it simply clarifies what must be shown to sustain a business transaction for tax purposes." (Emphasis added). *Johnson v. United States*, 11 Cl.Ct. 17, 58 AFTR2d 5894, 5900 (Cl.Ct. 1986)

However, the ninth circuit in the instant case explicitly rejected that rule.

> "[W]e did not intend our decision in [*Bail Bonds by Marvin Nelson, Inc. v. Commissioner*, 820 F.2d 1543, 60 AFTR2d 5272 (9th Cir. 1986)] to outline a rigid two-step analysis. Instead consideration of business purpose and economic substance are simply more precise factors to consider in the application of this court's traditional sham analysis; that is whether the transaction had any practical economic effect other than the creation of income tax losses. . . . *Thus, the tax court's failure to specifically delineate a two-prong test and the*

factual findings that support each prong is not itself fatal." (Emphasis added). *Sochin v. Commissioner,* 843 F.2d 351, 61 AFTR2d 946, (9th cir. 1988) See Appendix Page A-7.

Ironically, and just as troubling as the lack of uniformity among the circuits, the United States Tax Court, which tries most of the nation's tax cases, has no consistent approach to the sham issue. Sometimes it clearly and explicitly follows the fourth circuit's two-part test. *Rose v. Commissioner,* 88 T.C. 386, 408-411 (1987); *Gefen v. Commissioner,* 87 T.C. 1471, 1490 (1986); *Packard v. Commissioner,* 85 T.C. 397, 416-417 (1985). Other times it decides the sham issue with no stated standard at all. *Brown v. Commissioner,* 85 T.C. 968 (1985). In a third variation it sometimes holds that profit potential alone is the determining factor and no reference need be made to the taxpayer's true intentions and motives. *Cherin v. Commissioner,* 89 T.C. No. 69 (1987). And, finally, in yet a fourth approach, it sometimes decides cases using a list of supposedly objective "factors"; which, upon analysis have no reference to "factors" used in other cases and are actually nothing more than some of the elements that happen to appear in the case then at hand. *E.g. Freytag v. Commissioner,* 89 T.C. No. 60 (1987).

Therefore, the Supreme Court's hearing and deciding this case will clarify the law for hundreds of tax cases now pending in the lower federal courts, and will resolve a conflict among the circuit courts of appeal.

* * *

Respectfully submitted,

June 9, 1988
Date

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APPENDIX

(Supreme Court Rule 21.1(k))

* * *

FOR PUBLICATION

UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

JAMES E. SOCHIN, *Petitioner-Appellant,* v. COMMISSIONER OF INTERNAL REVENUE, *Respondent-Appellee.*	No. 87-7024 T.C. No. 2313-83
DENNIS S. BROWN, *Petitioner-Appellant,* v. COMMISSIONER OF INTERNAL REVENUE, *Respondent-Appellee.*	No. 87-7032 T.C. No. 29929-82 OPINION

Appeal from a Decision of the
Tax Court of the United States

Argued and Submitted
December 16, 1987 — San Francisco, California

Filed March 29, 1988

Before: Herbert Y. C. Choy, Alfred T. Goodwin and
Robert R. Beezer, Circuit Judges.

Opinion by Judge Choy; Concurrence by Judge Beezer

SUMMARY —

Taxation

Appeal from tax court's deficiency determinations. The court affirmed holding that the district court applied the proper legal standard for determining a sham and accordingly finding the transactions as such.

Appellant taxpayers claimed losses from investments in straddles in forward contracts to by and sell "Ginnie Maes" and "Freddie Macs." The investments were part of an investment program promoted by Gregory Government Securities, Inc. (GGS) and Gregory Investment and Management, Inc. (GIM). Under the program, no investor ever purchased or sold Ginnie Maes or Freddie Macs. Instead, all loss positions were canceled and all gain positions were assigned before the settlement date. The tax court found that adjustments to the contract price or fees charged generated the minor net profits or net losses reflected in investor accounts.

[1] Taxpayers argue that the tax court failed to apply the correct legal standards to determine whether the investments were shams. **[2]** Courts typically focus on the related factors of whether the taxpayer has shown a non-tax business purpose and that the transaction had economic substance beyond the generation of tax benefits. This is not a rigid two-step analysis. Thus, the tax court's failure to specifically delineate a two-prong test is not itself fatal. **[3]** Taxpayers failed to establish that the entire program did not exist solely to provide tax benefits for its investors and they were sufficiently sophisticated to know that the transactions were too good to be real. **[4]** Evidence admitted of other investor transactions in the GGS program was relevant to the sham determination. A consideration of the entire investment program relates to the analysis of taxpayers' probable economic benefits. **[5]** Under the facts, taxpayers invested in a program designed to reap the tax benefits of real market investments without bearing the consequent risks.

The concurrence writes separately to state that a transaction which is in substance only finanicial gymnastics, purely artificial, or a paper chase does not require any inquiry into the profit motive.

COUNSEL

Joseph Wetzel, Wetzel & DeFrang, Portland Oregon, for the petitioners-appellants.

Michael C. Durney, Acting Assistant Attorney General, Tax Division, Department of Justice, Washington, D.C., for respondent-appellee.

OPINION

CHOY, Circuit Judge:

James Sochin and Dennis Brown ("Taxpayers") appeal from the tax court's deficiency determinations. The court disallowed the losses and expenses deducted by Taxpayers with respect to investments in straddle transactions involving forward contracts. The court held that the transactions were "factual shams." *Brown v. Commissioner*, 85 T.C. 968, 998-1000(1985). On appeal, Taxpayers allege that the tax court: 1) failed to apply the proper legal standard for determining what a sham is; 2) failed to make adequate factual findings as required by 26 U.S.C. § 7459(b); 3) improperly considered evidence of other investors involved in the same investment program; and 4) based its sham determination on clearly erroneous factual findings. We affirm.

FACTUAL BACKGROUND

Taxpayers claimed losses from investments in straddles[1] in forward contracts[2] to buy and sell certificates issued by the Government National Mortgage Association ("Ginnie Maes") and the Federal Home Loan Mortgage Corporation ("Freddie Macs"). The investments were part of an investment program promoted by Gregory Government Securities, Inc. ("GGS") and Gregory Investment & Management, Inc. ("GIM"). William Gregory incorporated both organizations in Oregon in 1979. Under the program, GIM served as a financial adviser to prospective investors, while GGS, as a registered broker-dealer, was the requisite seller or buyer in each investor transaction.

A disclosure memorandum provided by GIM to each prospective investor purported to offer an interest rate speculation program. The investor informed GIM of his or her forecast of interest rates; GIM, in turn, would recommend a portfolio of forward contracts for Government securities that it believed would create a profit if the forecast was accurate. The memorandum also stated that the investor could request cancellation of a particular contract before its settlement date, at which point he or she would be credited or charged with any profit or loss, in addition to being charged a fee for the "risk and administrative costs created by the cancellation of the contract." The memorandum indicated the fees to be charged for each transaction. Furthermore, GGS had full authority to determine the contract prices.

The tax court found that the program worked essentially as follows: The investor would make a deposit (of the greater of $10,000 or .125 percent of the face value of the portfolio) and furnish GIM with an interest rate forecast. At this point, each investor executed a

[1]A straddle is the simultaneous holding of a buy and sell position in similar commodities.

[2]A forward contract is like a futures contract; i.e. an agreement to buy (long) or sell (short) a specific quantity of commodity at a specified price on an agreed upon future date (the "settlement" date).

customer agreement giving GGS full power to liquidate any open position whenever "necessary for [its] protection," with or without notice to the investor. Each investor also executed a power of attorney authorizing GIM to act for the investor. Based on the interest rate forecast, GIM would prepare a portfolio of forward contracts on Ginnie Maes and Freddie Macs. This original portfolio constituted a straddle, since fifty percent of the contracts were to purchase securities (long positions), and fifty percent were to deliver securities (short positions). Any significant change in the prevailing interest rate would result in a loss in one "leg" of the straddle; that leg would be canceled to create an ordinary loss for the investor in the year of cancellation. The court found that such losses generally approximated ten times the original investment. GGS would then replace the canceled contracts with similar contracts, thus reestablishing the straddle. GGS then entered into new contracts with the investor which offset or opposed the existing contracts to "lock in" the gain from the non-canceled leg of the original straddle. Finally, after the gain was deferred for a sufficient period of time, the contracts were assigned to a third party,[3] which allowed the investor to realize his gain. The amount payable to GGS from the initial cancellation of the loss leg was offset against the receivable due the investor in approximately the same amount as a result of the assignment of the gain leg.

No investor ever purchased or sold Ginnie Maes or Freddie Macs. Instead, all loss positions were canceled and all gain positions were assigned (and reassigned to GGS) before the settlement date. The tax court found that adjustments to the contract price or fees charged generated the minor net profits or net losses reflected in investor accounts.

Brown's experience with the program resulted in the following:[4] after proceeding through the process outlined above, his $10,000

[3]GGS assigned the contracts to closely associated third parties. These third parties immediately assigned the contracts back to GGS at the same price. Thus, these groups did not realize any income from the acquisition or disposition of the contracts, but were paid $100 from GGS for each assignment (which was charged to the investors account).

[4]Brown and Sochin represent two of four cases chosen as being generally representative of 1400 similar cases pending before the tax court.

investment generated a $100,160 ordinary loss in 1979, and a $106,382 net long-term capital gain in 1981. The net gain of $6,222 before taxes was reduced to a net overall profit of $122 after the deduction of $6100 in fees. Brown deducted the alleged losses and reported the subsequent gains on his federal income tax returns for 1979 and 1981, respectively. Sochin, who was employed by Harsh Investment Corporation, participated in the program with a group of the corporation's employees. His $2000 portion of the group investment generated a $20,080 ordinary loss in 1979, and a $21,961 net long-term capital gain in 1981. The net gain of $1,881 before taxes was reduced to a net overall profit of $461 after the deduction of $1,420 in fees.[5]

[5] Sochin also participated in the program in 1980, and 1981. The transactions were similar to his 1979 investment, except that he experienced slight net losses rather than gains each year.

DISCUSSION

I. *The Proper Legal Standard for the "Sham" Determination*

[1] Taxpayers argue that the tax court failed to apply the correct legal standard to determine whether the investments were shams. The tax court's conclusion that the transactions were shams is a finding of fact that is reviewed under the clearly erroneous standard. *Bail Bonds by Marvin Nelson, Inc. v. Commissioner*, 820 F.2d 1543, 1548 (9th Cir. 1987). However, the legal standard applied by the tax court in making the sham determination is reviewed de novo.[6] *Id.*

[6] In 1984, Congress enacted section 108 of the Deficit Reduction Act of 1984, Pub.L.No. 98-369, 98 Stat. 494, 630-31, which governs the allowance of pre-June 24, 1981 straddle loss deductions. Under section 108, a loss resulting from a straddle transaction is deductable if the investor had a "reasonable expectation of profit." *Wehrly v. United States*, 808 F.2d 1311, 1314 (9th Cir. 1986). However, the "reasonable expectation of profit" standard is not applied until the court determines that the transaction is itself bona fide, i.e. that it is not a sham. *See Enrici v.*

A. *The Proper Test*

[2] We noted in *Bail Bonds* that courts "typically focus" on the related factors of whether the taxpayer has shown 1) a non-tax business purpose (a subjective analysis), and 2) that the transaction had "economic substance" beyond the generation of tax benefits (an objective analysis). 820 F.2d at 1549. However, we did not intend our decision in *Bail Bonds* to outline a rigid two-step analysis. Instead, the consideration of business purpose and economic substance are simply more precise factors to consider in the application of this court's traditional sham analysis; that is, whether the transaction had any practical economic effects other than the creation of income tax losses. *See, e.g., Neely v. United States,* 775 F.2d 1092, 1094 (9th Cir. 1985); *Thompson v. Commissioner,* 631 F.2d 642, 646 (9th Cir. 1980), *cert. denied,* 452 U.S. 961 (1981). Thus, the tax court's failure to specifically delineate a two-prong test and the factual findings that support each prong is not itself fatal.

B. *The Tax Court's Legal Standard*

[3] The tax court's analysis indicates that it considered the proper factors and applied the correct legal standard to reach its conclusion. After noting that the loss must result from a "bona fide transaction," the court held that Taxpayers "failed to establish that the entire program . . . did not exist solely to provide tax benefits for its investors." *Brown,* 85 T.C. at 988. Further, the court likened the transactions to those in *Julien v. Commissioner,* 82 T.C. 492 (1984), in which the disallowance was based on a finding that the transaction served no economic function other than the generation of tax deductions. 85 T.C. at 999. Finally, in discussing the imposition of damages, the court held that "[Taxpayers] were sufficiently knowledgeable and sophisticated with respect to business and tax matters to have known, and actually did know, . . . that the transactions were "too good" to be real and therefore were shams." *Id.* at 1001.

Commissioner, 813 F.2d 293, 295 n.1 (9th cir. 1987); *Mahoney v. Commissioner,* 808 F.2d 1219, 1220 (6th Cir. 1987). Thus, the tax court in the present case never reached section 108.

In short, the tax court reviewed the transactions for economic effects other than the creation of income tax losses, and in doing so considered both economic substance and business purpose. The court thus applied the proper legal standard.

II. *Factual Findings Under 26 U.S.C. §7459(b)*

Title 26 U.S.C. § 7459(b)(1982) requires the tax court to "report in writing all its findings of fact." Taxpayers allege that the tax court's factual findings failed to account for substantial evidence presented at trial.

Findings of fact are sufficient if they provide the appellate court with a clear understanding of the basis of the lower court's decision and the grounds upon which it reached that decision.[7] *Unt v. Aerospace Corp.*, 765 F.2d 1440, 1444 (9th Cir. 1985); *Nicholson v. Board of Education Torrance Unified School District*, 682 F.2d 858, 866 (9th Cir. 1982). This court will not reverse because of inadequate factual findings "unless a full understanding of the question is not possible without the aid of separate findings." *Vance v. American Hawaii Cruises*, 789 F.2d 790, 792 (9th Cir. 1986).

While the tax court did not specifically account for the basis upon which a great deal of testimony was discounted or disregarded, its twenty-eight pages of factual findings clearly outline its conclusions regarding the operation of the investment program. The court's findings are "sufficient to indicate the factual basis for its ultimate conclusions." *Id.* We thus deny Taxpayers request for a remand based on §7459(b).

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[7] We adopt this proposition from cases decided under Fed. R. Civ. P. 52(a), which states that in non-jury trials, "the court shall find the facts specially and state separately its conclusions of law. . . ." This court has previously cited Rule 52(a) cases and §7459(b) cases interchangeably. For example, *Handeland v. Commissioner, 519 F.2d 327, 329 (9th cir. 1975), a tax case, cited Rayonier, Inc. v. Polson,* 400 F.2d 909, 923 (9th Cir. 1968), a Rule 52(a) case, in its description of the findings "federal courts" must make to support their conclusions. In turn, *McCune v. F. Alioto Fish Co.*, 597 F.2d 1244, 1249 (9th Cir. 1979), a Rule 52(a) case, cited *Handeland* for the same purpose.

III. *Admission of Evidence of Other Transactions*

Taxpayers argue that the tax court erred in considering evidence of transactions of other investors in concluding that the investments were shams. The court admitted the evidence in order to determine whether the Taxpayers' transactions were bona fide. *See Brown,* 85 T.C. at 972 n.6.

We review the trial court's decision to admit or exclude evidence based on the issue of relevancy for an abuse of discretion. *Lies v. Farrell Lines,* 641 F.2d 765, 773 (9th Cir. 1981).

[4] Federal Rule of Evidence 401 defines relevant evidence as "evidence having any tendency to make the existence of any fact that is of consequence to the determination of the action more probable or less probable than it would be without the evidence." The tax court admitted evidence of other investor transactions in the GGS program as relevant to the sham determination. As discussed above, at least part of the sham analysis focuses on the "economic substance" of the transaction; i.e. whether it was "likely to produce economic benefits aside from a tax deduction." *Bail Bonds,* 820 F.2d at 1549. A consideration of the entire investment program directly relates to the analysis of Taxpayers probable economic benefits. It is also directly relevant to the court's assessment of Taxpayers' credibility with respect to their assertions of a non-tax based motive. The tax court acted well within its discretion in considering the evidence.[8]

IV. *The Tax Court's Findings of Fact*

Taxpayers' final argument is that several of the tax court's findings of fact with respect to the sham determination are clearly erroneous. We note at the outset that the tax court's ultimate conclusion that

[8]As Taxpayers acknowledge, we have previously allowed evidence in tax cases of transactions involving persons not before the court. *See Goldberg v. United States,* 789 F.2d 1341, 1344 (9th Cir. 1986); *Karme v. Commissioner,* 673 F.2d 1062, 1064 (9th Cir. 1982).

the transactions were shams is itself a finding of fact which will not be reversed unless clearly erroneous.[9] *Bail Bonds,* 820 F.2d at 1548; *Thompson,* 631 F.2d at 646. The clearly erroneous standard is particularly apporpriate when, in instances such as this, the sham determination is based in part on the evaluation of conflicting evidence and live testimony. *Enrici,* 813 F.2d at 295. Finally, as we indicated in a previous sham case, "[t]he expertise that the Tax Court brings to bear in its consideration of these complex factual situations provides . . . further reason to defer to its conclusion." *Thompson,* 631 F.2d at 646.

[5] Application of these principles to the facts of this case clearly supports the tax court's conclusion that the transactions were shams. The entire program existed within a self-contained market operated and controlled by Mr. Gregory and his affiliates. The absolute power that Taxpayers conferred upon GGS to set contract prices and perform any act to alter existing contractual obligations, combined with the fact that no contract was ever enforced, entitled the tax court to infer that the entire program existed solely to provide tax benefits.[10] Even assuming the pricing formula utilized was commercially acceptable, the complete authority to "manipulate and dictate the price and timing of the artificial transactions . . . allows a taxpayer . . . to reap larger and surer tax advantages with much less economic risk than he would have had he entered into real transactions." *Enrici,* 813 F.2d at 296. Indeed, no reasonable investor would surrender total control of his or her ability to profit or lose unless satisfied that the risk of loss

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[9] In addition, the Commissioner's determination that the transaction is a sham is presumptively correct, and Taxpayers have the burden of producing evidence to rebut the deficiency determination and burden of persuasion to substantiate the deduction. *Goldberg,* 789 F.2d at 1343; *see Welch v. Helvering,* 290 U.S. 111, 115 (1933).

[10] Taxpayers contest the tax court's conclusion that price and fee "adjustments" accounted for the slight profits or losses reflected in some of the accounts. Yet, in a number of instances, fees actually charged varied significantly from those indicated in the disclosure memorandum. Thus, the tax court's rejection of Taxpayers testimony that the fees were subsequently "negotiated" is not clearly erroneous.

As to the pricing formula, it is uncontested that the customer agreement gave GGS full power to determine the prices at which the contracts were executed.

had been greatly diminished or eliminated. In short, Taxpayers invested in a program designed to reap the tax benefits of real market investments without bearing the consequent risks.[11]

Taxpayers' other allegations of clearly erroneous factual findings are unpersuasive in light of the economic realities surrounding the GGS-controlled "marketplace."[12] The tax court concluded that "the losses claimed by [Taxpayers] are not allowable because the disputed transactions constituted factual shams which were inspired, designed, and executed by Mr. Gregory and the two corporations controlled by him for the sole purpose of attempting to achieve tax losses for their investors." *Brown*, 85 T.C. at 1000. This conclusion is not clearly erroneous.

CONCLUSION

Taxpayers have failed to carry the burden of producing evidence to rebut the Commissioner's deficiency determinations and substantiate the deductions. Accordingly, the tax court's decision is AFFIRMED.

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[11] Further, as we noted in *Enrici*, "the claiming of deductions from artificial straddles that are designed to look similar to marketplace straddles . . . has a much greater potential for abuse than deductions from marketplace straddles." 813 F.2d at 296.

[12] For example, Taxpayers strongly criticize the tax court's failure to find that the investment contracts were enforceable. However, the client agreement signed by each investor gave GGS the authority to enter into or cancel any contractual obligation with or without notice to the investor. Further, as noted previously, no contract was ever enforced. Thus, the tax court may have concluded that the alleged contractual obligation was illusory. Such a conclusion is not clearly erroneous. *See Bail Bonds*, 820 F.2d at 1550 (absense of arm's length dealing and lack of evidence demonstrating that obligation to repay loans was genuine supports conclusion that alleged legal obligation to repay loans was purely formal; thus, interest on loans not deductible).

BEEZER, J., concurring:

I cannot reconcile *Bail Bonds By Marvin Nelson, Inc. v. Commissioner,* 820 F.2d 1543 (9th Cir. 1987) with our prior precedent. There we applied the two-prong disjunctive test adopted by the Fourth Circuit in *Rice's Toyota World, Inc. v. Commissioner,* 752 F.2d 89 (4th Cir. 1985). Unlike the genuine recourse indebtedness in *Rice's,* however, the transaction in *Bail Bonds* existed only on paper.

I believe that a transaction which is in substance only "financial gymnastics," purely artificial, or a "paper chase" does not require any inquiry into the profit motive. *Enrici v. Commissioner,* 813 F.2d 283, 295 n.1 (9th Cir. 1987); *Mahoney v. Commissioner,* 808 F.2d 1219, 1220 (6th Cir. 1987); *see Goldberg v. United States,* 789 F.2d 1341 (9th Cir. 1986) (affirming sham determination focusing entirely on economic substance); *Neely v. United States,* 775 F.2d 1092 (9th Cir. 1985) (invalidating putative tax consequences of sham trust on grounds that it had "no economic effect other than to create income tax losses"); *Thompson v. Commissioner,* 631 F.2d 642 (9th Cir. 1980) (economic substance); *Karme v. Commissioner,* 673 F.2d 1062 (9th Cir. 1982) (economic substance).[1]

I express no opinion whether the two prong disjunctive test adopted in *Rice's* properly applies to genuine transactions; such is not the case here.

The Tax Court should be affirmed.

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[1] I agree with the opinions's footnote 6 which states that section 108 of the Deficit Reduction Act of 1984 does not apply to transactions that are not bona fide. For that reason, this court's opinion in *Wehrly v. United States,* 808 F.2d 1311 (9th Cir. 1986), and the Tenth Circuit's recent opinion in *Miller v. Commissioner,* No. 85-2766 (10 Cir. Jan. 11, 1988), are inapposite.

DENNIS S. BROWN, ET AL.,[1] PETITIONERS v. COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket Nos. 29929-82, 2313-83 3083-83, 3503-83. Filed December 18, 1985.

Petitioners claimed deductions for fees and losses allegedly incurred with respect to forward contracts for purchase and sale of Ginnie Maes and Freddie Macs. *Held,* the forward contracts and related transactions were factual shams and the deductions for fees and losses are disallowed. *Held, further,* the addition to tax under sec. 6653(a) I.R.C. of 1954 as determined by respondent against one petitioner is sustained, but damages under sec. 6673 are declined.

Joseph Wetzel and *Russell Sandor,* for the petitioners.
Ralph C. Jones and *Joyce Britt,* for the respondent.

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[1] Cases of James E. Sochin, docket No. 2313-83; Ellison C. Morgan and Linda Morgan, docket No. 3083-83; and James N. Leinbach and Mary Alice Leinbach, docket No. 3503-83, were consolidated herewith for trial, briefing, and opinion.

SHIELDS, *Judge*: Respondent determined deficiencies in petitioners' Federal income tax as follows:

Petitioner[2]	*Year*	*Deficiency*	*Additions to tax sec. 6653(a)*[3]
Brown	1979	$49,562.50	
Sochin	1979	9,402.00	
	1980	25,535.00	
	1981	18,288.00	
Morgan	1977	2,283.00	$114.00
	1979	104,022.00	5,217.35
	1980	194,141.55	10,141.55
Leinbach	1979	205,181.69	
	1980	263,728.31	
	1981	218,036.46	

After concessions, the issues remaining for decision are: (1) Whether petitioners realized deductible losses under section 165(c)(2) on forward contracts as claimed on their income tax returns for 1979, 1980, and/or 1981; (2) whether the fees paid by petitioners with respect to such contracts are deductible; (3) whether petitioners, Ellison C. Morgan and Linda Morgan, are liable for additions to tax under section 6653(a); and (4) whether any of the petitioners are liable for damages under section 6673.

[2]Since Linda Morgan and Mary Alice Leinbach are petitioners solely because they filed joint returns with their husbands, the word "petitioners" as used hereinafter will refer only to the male petitioners unless otherwise indicated.

[3]All section references are to the Internal Revenue Code of 1954 as amended and in effect during the years in issue. All rule references are to the Tax Court Rules of Practice and Procedure.

FINDINGS OF FACT

Some of the facts have been stipulated and are so found. The stipulations and exhibits associated therewith are incorporated herein by reference.

All of the petitioners resided in Oregon at the time their petitions were filed, and all of them filed income tax returns for 1979, 1980, and 1981 with the Internal Revenue Service Center at Ogden, Utah. On the returns, petitioners claimed to have suffered losses in the following amounts from the cancellation of forward contracts for the purchase or sale of certain mortgage certificates:

Petitioner	*Year*	*Loss claimed*
Brown	1979	$106,160
Sochin	1979	20,621
	1980	48,054
	1981	38,785
Morgan	1979	224,416
	1980	390,614
Leinbach	1979	394,676
	1980	482,245
	1981	401,412

All of the above losses allegedly[4] occurred with respect to activities promoted by Gregory Government Securities, Inc., and Gregory Investment & Management, Inc. Over 1,400 other cases now pending before this Court have been identified as involving similar issues and factual situations. Upon learning of the number of such cases, the Chief Judge assigned all of them to this division of the Court. With the assistance of respondent and his counsel, and most of the 1,400 petitioners and their counsel, these four cases were selected

[4]The use in our findings of such words and phrases as loss, gain, forward contract, cancellation, assignment, spread, straddle, short position, long position, transactions and similar words and phrases are for convenience only and are not to be construed as a determination of the nature of any act or thing.

as being generally representative with respect to the issues common to all the cases.[5] An order was then entered consolidating these four cases and setting them for trial of the common issues while all activity in the other cases was suspended pending the decision herein.

Gregory Government Securities, Inc. (GGS), and Gregory Investment & Management, Inc. (GIM) were incorporated in 1979 by William H. Gregory under the laws of the State of Oregon. At all times material to these cases, all of the stock outstanding in both corporations was owned by Mr. Gregory and his wife, and their corporate activities were conducted under his general supervision and control. Prior to 1979, Mr. Gregory had been the tax partner and a specialist in accounting for wood products with Arthur Andersen & Co., an international accounting firm. He was also the chairman of the firm's steering committee on tax shelters. He left Arthur Andersen in July of 1979 in order to establish GGS and GIM. Shortly after its organization, GGS was registered with the Oregon Department of Commerce as a broker-dealer in securities. The registration continued through the balance of 1979 and throughout 1980 and 1981. No such registration was required of GIM in Oregon. Neither corporation was required to be registered as a broker-dealer under the Securities Exchange Act of 1934.

The promotion undertaken in 1979 by Mr. Gregory was purportedly to offer to "a limited number of knowledgeable, sophisticated investors, * * * who understand both the economic and tax ramifications of the transactions," investments in forward contracts to purchase or to sell certificates issued by Government National Mortgage Association and Federal Home Loan Mortgage Corporation. These certificates are exempt from federal registration under the Securities Act of 1933. His program contemplated that GIM would serve as a financial adviser to the prospective investors, and GGS, as a registered broker-dealer, would serve as either a seller or a buyer on every transaction entered into with the investors.

[5] The additional loss issue raised by petitioner Morgan in his amended pleading filed Apr. 19, 1984, was not considered herein because these proceedings deal only with the issues common to all petitioners. The additional issue will be considered in a later proceeding.

Government National Mortage Association (GNMA) is a corporation wholly owned by the Government through the Department of Housing and Urban Development. From time to time, GNMA issues registered certificates which represent undivided interests in a specified pool of mortgages guaranteed by GNMA, as well as by the Veterans' Administration, the Federal Housing Administration, or the Farmers Home Administration. These certificates are referred to in the market as "Ginnie Maes."

The Federal Home Loan Mortgage Corporation (FHLMC) is a corporation whose capital stock is owned by the Federal Home Loan Bank Board and whose directors are appointed by the President with the advice and consent of the Senate. The directors of the Federal Home Loan Bank Board act as the directors of FHLMC.

FHLMC also sells mortgage certificates which are known as participation certificates and which are referred to in the market as "Freddie Macs." Each of these certificates represents an undivided fractional interest in a pool of conventional (non-VA and non-FHA) mortgages.

Each prospective investor,[6] including petitioners herein, was given a disclosure memorandum by GIM in which the investment strategy developed by Mr. Gregory was described as follows:

> Gregory Investment assists investors in profiting from changes in yields on U.S. Government securities. The investor provides us with his forecast of interest rates. We recommend a portfolio of U.S. Government securities that we believe will result in a gain, if the investor's forecast is correct.
>
> The investment usually involves the purchase and sale of securities under arrangements that delay the actual delivery of a security for several months. This type of arrangement is referred to as a forward contract.
>
> A forward contract is a bilateral executory agreement pursuant to which one party agrees to deliver a designated amount of an item at a certain price and time to another party, who agrees to acquire such item at such price and time. The forward contract does not require delivery until the settle-

[6] At trial and on brief, petitioners contended that evidence of transactions between Mr. Gregory, GGS, or GIM and any investor other than petitioners is not relevant to the issues under consideration and therefore should not be admitted. After due consideration, we affirm the temporary decision made at the trial that such evidence is admissible in order to determine whether the transactions with petitioners are bona fide.

ment date designated in the contract. A forward contract is similar in concept to a futures contract. However, a futures contract is consummated through a board of trade or an exchange and contains standardized terms and conditions. The securities purchases and sales through forward contracts are limited to obligations of, or obligations guaranteed by, the United States Government, and securities issued by or guaranteed by United States Government corporations or agencies; e.g., Government National Mortgage Association (GNMA) or Federal Home Loan Mortgage Corporation (FHLMC). The customer is required by the contract to make delivery to, or take delivery from, the dealer of the security specified in the forward contract at settlement date.

It is contemplated that a customer will enter into several forward contracts with the dealer, some of which will require the customer to make forward delivery to the dealer of securities, while others will require the customer to take forward delivery from the dealer of securities. The forward contracts entered into by a particular customer will reflect a market strategy and interest rate forecast and could result in substantial gain or loss to the customer, depending on the volume of transactions and whether interest rate movement is in accordance with, or adverse to, his expectations.

The investment risk is diminished by the simultaneous purchase and sale of a forward contract. This purchase and sale is called a spread. The profit and loss potential of a spread results from the purchase of securities and the sale of securities with different coupon interest rates.

A change in interest rates affects the price of a low-coupon security a greater percentage than a high-coupon security. However, the low-coupon security costs less, so even though its price varies at a greater percentage rate, the total change in price is less.

The usual investment strategy to profit from rising interest rates is to *purchase low-coupon* and *sell high-coupon* securities. An opposite strategy would be used for a projected decline in interest rates.

For example—

Assume a 9% current yield to maturity on a security paying interest semi-annually and maturing in ten years. The investor forecasts interest rates to rise to 10%. This spread results in a profit:

			Price		
	Coupon rate	*Face value*	*9-Percent yield*	*10-Percent yield*	*Profit (loss)*
Purchase (long)	8%	\$1,000,000	\$935,000	\$875,400	\$(59,600)
Sell (short)	9	1,000,000	1,000,000	937,700	62,300
					2,700

The profit would be reduced by transaction costs.

* *

In the event a customer desires to be released from obligations under a particular forward contract, the customer may attempt to arrange for the cancellation of the obligations under the contract prior to settlement date. If the dealer agrees to cancel the contract, it will charge or credit the customer's account with an amount equal to the profit or loss that the customer is entitled to receive. In consideration for the release of the customer from his obligation to perform the contract the customer will also pay a fee to the dealer for risk and administrative costs created by the cancellation of a contract.

Alternatively, if the customer does not desire to be released from the obligations under a particular forward contract (original contract), but wants to eliminate the risk created by such contract, he may enter into a forward contract bearing the position opposite that of the original contract. The customer may request that the dealer offset the newly acquired contract against the original contract or he may keep both positions open and either offset at a later date or close out the position in some other manner.

The tax and economic results of various types of transactions are summarized below. The federal income tax results should be discussed with your tax advisor and you should not rely on the chart. The results could be challenged for various reasons by the Internal Revenue Service, as explained in the tax aspects section of this memorandum.

TRANSACTION	*FEDERAL INCOME TAX RESULTS*	*ECONOMIC RESULTS*
Delivery of security	Long position: none until securities are sold. Short position: short-term capital gain or loss	Gain or loss is realized. Additional margin may be required because of increased risk unless a spread is re-established or all positions are closed.
Sale or assignment	Long-term capital gain or loss on contracts held over 1 year. Short-term 1 year or less.	
Cancellation	Ordinary gain or loss.	
Offset or pair-off of identical contract	Short-term capital gain or loss on all short positions and on all long positions held for 1 year or less on date of short sale.	
Opposing purchase or sale of securities identical to open positions	None	Establishes no risk situation locking in gain or loss for later realization.
Opposing purchase or sale of securities different from open positions	None	Establishes spread with potential for gain or loss.

The memorandum stated that the forward contracts were not listed on any security or commodity exchange; that each contract was between the investor as one party and GGS as the other; that the investor could not sell or assign his interest in any contract without the consent of GGS; that if the investor wished to be released from the obligations of a particular forward contract before its settlement date, he had the right to request that GGS cancel the contract; and that if GGS agreed to do so, the investor's account would be credited by GGS with an amount equal to any profit the investor was entitled to receive or charged with any loss he had suffered on the contract plus a fee for the "risk and administrative costs created by the cancellation of the contract."

The memorandum also stated that each investor was required to have on deposit with GGS a sufficient amount to cover his investment risk which amount would vary with the size of the portfolio and the risk involved but the initial deposit would be a minimum of $10,000

or 0.125 percent of the face value of the portfolio, whichever was greater. An advisory fee of 0.001 percent per month was to be paid out of the deposit with GGS to GIM. In addition, an origination fee of 0.04 percent of the contract's face value was payable on the trade date, and the fee for the cancellation of a contract was stated to be 0.02 percent of the face value on the cancellation date. GGS could also include a markup or a discount on any security covered by a contract.

Potential investors were warned by the disclosure memorandum that they could lose all of their deposit in a relatively short period of time and that in order to achieve a profit, the market would have to move in the direction forecast and by an amount that covered all fees plus or minus any markup or discount.

GIM's disclosure memorandum contained 14 pages, 4 of which were devoted to the tax treatment that Mr. Gregory thought an investor could expect as a result of entering into a transaction with GGS and GIM. Briefly, the transaction would proceed as follows: (1) The investor would make his deposit and furnish GIM with an interest rate forecast for the next 3, 12, and 15 months. (2) Using the interest forecast GIM, acting as an investment adviser, would prepare a portfolio of forward contracts on Ginnie Maes and Freddie Macs in the face amount required by the deposit and which, if the investor's prediction proved to be correct, would supposedly result in a profit. (3) Each of the forward contracts was entered into by the investor with GGS. In each case, the original portfolio for an investor constituted a spread or straddle since 50 percent of the contracts were long positions (contracts to purchase securities) and 50 percent were short positions (contracts to deliver securities). (4) As time passed and it became apparent which leg of the straddle would result in a loss,[7] that leg would be canceled and the gain in the other leg of the straddle would be locked in by entering into an offsetting or opposing contract to purchase or sell until such time as the investor wished to realize his gain (presumably after it became a long-term capital gain).

[7] Everything else being equal, any significant change either up or down in the prevailing interest rate would result in a gain in one leg and a loss in the other.

According to GIM's memorandum, the tax result of the above transaction would be an ordinary loss for the investor in the year of the cancellation of the loss contracts and a long-term capital gain in the year the gain was realized by the sale or assignment of the gain contracts. The memorandum, however, did contain the following caveat:

> Due to the tax deferral and conversion of tax characteristics (i.e., capital versus ordinary) involved in the transactions described in the memorandum, the Service may take a strong stance contrary to the opinions expressed herein. Additional legislative action or Service rulings or regulations could also be enacted or issued negating any tax benefits that would otherwise be available to the investor as discussed in this memorandum. Further, if a court should feel that tax deferral or conversion is involved, it might be inclined to hold in favor of the Service, even though the opinions expressed in this memorandum are technically correct. The investor should review the tax treatment of the transactions discussed in this memorandum with his tax advisor and rely only upon the advice of his own tax advisor. The opinions expressed herein are only for purposes of providing information and analysis to the investor and his tax advisor.

Attached to the disclosure memorandum is a copy of the Service's Rev. Rul. 77-185, 1977-1 C.B. 48, 50. This ruling holds that "Neither a short-term capital loss created to minimize the tax consequences of an unrelated short-term capital gain through a series of transactions in silver futures contracts, which result in no real economic loss, nor the related out-of-pocket expenses incurred in connection with creating the loss are deductible under section 165(a) of the Code."

In spite of the caveat, prospective investors were advised that with a minimum deposit of $10,000 they could obtain forward contracts with GGS having a total face value of $8 million. They were also advised that for the minimum deposit, one or the other of the long or short positions (depending on the direction of the movement in the interest rate) would result in an ordinary loss in the approximate amount of 10 times the deposit or $100,000.

Each investor was required to sign a client or customer agreement which provided, among other things, that whenever GGS "considered it necessary for [its] protection," GGS could liquidate any

open position or cancel any order through public or private action with or without notice to the investor; and in the event of death or incapacity of an investor, GGS could take any step it deemed appropriate to cancel or complete any open position. A power of attorney was also obtained from every investor. Under the power of attorney, GGS was authorized to follow the investment instructions of GIM in every respect, and GIM was authorized to act for the investor and perform in his behalf any act which he could perform in person. The power of investor "ratif[ied] and confirm[ed] any and all transactions with [GGS] heretofore or hereafter made by [GIM] or for [his] account."

Even though GGS was a party to each of the forward contracts entered into by petitioners and had the right to include a markup or discount in any transaction, Mr. Gregory and David Solberg, the vice president and later president of GGS, admitted that neither GGS nor GIM made any profit from the contracts. Instead, their profits were generated from the advisory, origination, cancellation, and other fees.

GGS was required by the deputy corporation commissioner for the State of Oregon to establish and maintain a hedging program in publicly traded Ginnie Maes to insure its performance on forward contracts. GGS supposedly satisfied this requirement by hedging its net exposure on the total of its forward contracts by an offset with publicly traded Ginnie Maes.[8]

Under the client agreement, GGS had the authority to determine any price required under the contracts including cancellation prices. In order to arrive at a price, GGS purportedly used an elaborate formula consisting of approximately 20 steps. The first step was the receipt

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[8]GIM's disclosure memorandum contains the following provision on the risk of non-performance:

"Government Securities' [GGS's] ability to perform its obligation on settlement date will depend on the financial condition of Government Securities. Government Securities attempts to limit its economic risk by hedging its forward contract positions with either offsetting sales to or purchases from other customers. To the extent that Government Securities may have an imbalance between its long and its short positions (i.e., its net exposure), it will attempt to minimize that risk with offsetting purchases or sales of GNMA securities or GNMA futures contracts."

of a quotation in the open market for the then-current 8-percent Ginnie Maes. This price was then converted to a yield stated as a percentage which was used in computing a comparable value for the security being priced. The formula contained several other adjustments to be made in arriving at a price for a contract. Surprisingly enough, these included a step which allowed GGS to make any adjustment it felt was appropriate. At trial, Mr. Gregory admitted that on more than one occasion price concessions had been made to an investor if he felt that the investor's pricing expectations would be "disappointed" by adhering too strictly to market quotations or pricing formulas.

Following generally the procedure outlined in GIM's disclosure memorandum, petitioners and all other investors in the program made their respective deposits and furnished their interest forecasts to GIM and, in return, received documents which indicated their entry into forward contracts with GGS to purchase and sell Ginnie Maes and Freddie Macs. The documents included copies of the interest forecasts, forward contracts, powers of attorney, and client agreements referred to in the memorandum. The documents consisted of standard preprinted forms provided by GIM, and no negotiation or alterations by the investors was permitted as to their terms except with respect to the interest forecasts. The forms were executed by the investors or were executed for them by GIM pursuant to the powers of attorney. For the most part, investors in the Gregory program first became aware of the terms of their contracts when they received copies from GGS.

The interest rate forecasts made by petitioners for 1979 were as follows:

	Brown	*Sochin*	*Morgan*	*Leinbach*
Date of forecast	10/03/79	09/18/79	09/28/79	10/03/79
Current rate	10.9	10.586	10.8	10.915
3 Months	up 40	up 50	up 40	up 40
12 Months	down 100	down 90	down 100	up 100
15 months	down 150	down 100	down 150	down 100

For illustration purposes, Brown's forecast which was made on October 3, 1979, was to the effect that the 10.9-percent rate at which

8-percent Ginnie Maes were then trading on the Chicago Board of Trade would increase in 3 months by 40 basis points (0.04 percent), decrease in 12 months by 100 basis points (0.1 percent), and decrease in 15 months by 150 basis points (0.15 percent). Each of the other forecasts can be interpreted in a similar manner.

Each petitioner gave his 1979 forecast to GIM together with his 1979 deposit and, shortly thereafter, was furnished by GGS with a portfolio containing the forward contracts recommended by GIM, which according to GIM and GGS, would generate for petitioner a tax deduction of approximately $10 for each $1 of his deposit plus a gain if petitioner's interest forecast proved to be accurate.

Brown's account number with GGS was 135 and, according to the records of GGS, a transcript of the activity in the account with respect to the 1979 investment is as shown in the table on page 980.

The above transcript of Brown's account purportedly indicates that in return for his $10,000 deposit the initial portfolio recommended by GIM for him contained forward contracts 1 to 7 (all dated October 4, 1979) of which the first three represented agreements by Brown to buy Ginnie Maes from GGS having a total value of $4 million, and the last four of which represented agreements by Brown to sell to GGS Freddie Macs having a total value of $4 million. Six days later, on October 10, 1979, the contracts to buy Ginnie Maes (1 to 3) were canceled by GGS at an ordinary loss for Brown of $100,160[a] and the $4 million in Freddie Macs included in the remaining sell contracts (4 to 7) were offset by contract number 8 to buy Freddie Macs from GGS in the amount of $4 million. On October 26, 1979, Brown's position in the buy and sell contracts of 4 to 8 were locked down by the contracts of 9 to 13.

On January 22, 1981, both the contracts to buy and the contracts to sell Freddie Macs (4 to 13) were disposed of at a net long-term capital gain to Brown of $106,382 by an assignment to RST Investment Co. (RST), a partnership. RST was an investor with GGS and GIM and its members were business associates of Mr. Gregory. The assignment was executed for Brown by GIM under his power of attorney.

[a]The record does not contain an explanation for the difference between this figure and the figures used on the return and the statutory notice, both of which reflect a loss of $106,160.

1979

DENNIS S. BROWN

GREGORY GOVERNMENT SECURITIES ACCOUNT NUMBER 135

Contract number	DSB buy/sell	Amount	Type	Trade date	Percent	Settle date	Settle price	Disposition date	Disposition price	Gain/(loss)	
1	Buy	2.0	GNMA	10/04/79	7.5	3/10/81	78.464	C 10/10/79	76.003	($49,220)	
2	Buy	1.0	GNMA	10/04/79	8.25	3/01/81	82.546	C 10/10/79	80.010	(25,360)	
3	Buy	1.0	GNMA	10/04/79	9.0	3/30/81	84.943	C 10/10/79	82.385	(25,580)	($100,160)
4	Sell	1.0	FHLMC	10/04/79	8.75	3/15/81	84.025	A 1/22/81	76.7572	72,678	
5	Sell	1.0	FHLMC	10/04/79	9.0	4/01/81	84.443	A 1/22/81	77.1969	72,461	
6	Sell	1.0	FHLMC	10/04/79	9.25	2/15/81	85.416	A 1/22/81	78.1425	72,735	
7	Sell	1.0	FHLMC	10/04/79	9.5	3/01/81	86.365	A 1/22/81	79.0841	72,809	
8	Buy	4.0	FHLMC	10/10/79	8.0	4/15/81	78.500	A 1/22/81	73.8769	(184,924)	
9	Sell	4.0	FHLMC	10/26/79	8.0	5/15/81	74.9974	A 1/22/81	73.8769	44,820	
10	Buy	1.0	FHLMC	10/26/79	8.75	4/15/81	77.8633	A 1/22/81	76.7572	(11,061)	
11	Buy	1.0	FHLMC	10/26/79	9.0	5/01/78	78.3042	A 1/22/81	77.1969	(11,073)	
12	Buy	1.0	FHLMC	10/26/79	9.25	3/15/81	79.2472	A 1/22/81	78.1425	(11,047)	
13	Buy	1.0	FHLMC	10/26/79	9.5	4/01/81	80.1857	A 1/22/81	79.0841	(11,016)	
										A net gain =	106,382
										C + A net, net gain	6,222
										Fees	(6,100)
										Net profit to client	122

1979
HARSH ASSOCIATES
(James E., Sochin (1/6))

GREGORY GOVERNMENT SECURITIES ACCOUNT NUMBER 112

Contract number	*JES buy/sell*	*Amount*	*Type*	*Trade date*	*Percent*	*Settle date*	*Settle price*	*Disposition date*	*Disposition price*	*Gain/(loss) (JES share)*	
1	Buy	2.4	GNMA	9/18/79	7.5	3/10/81	80.515	C 10/04/79	78.056	($9,836)	
2	Buy	1.2	GNMA	9/18/79	8.25	3/01/81	85.231	C 10/04/79	82.662	(5,138)	
3	Buy	1.2	GNMA	9/18/79	9.0	3/30/81	87.047	C 10/04/79	84.494	(5,106)	($20,080)
4	Sell	1.2	FHLMC	9/18/79	8.75	3/15/81	86.140	A 12/17/80	76.4849	19,302	
5	Sell	1.2	FHLMC	9/18/79	9.0	4/01/81	86.547	A 12/17/80	76.9291	19,236	
6	Sell	1.2	FHLMC	9/18/79	9.25	2/15/81	87.531	A 12/17/80	77.8741	19,314	
7	Sell	1.2	FHLMC	9/18/79	9.5	3/01/81	86.513	A 12/17/80	78.8149	19,396	
8	Buy	4.8	FHLMC	10/04/79	8.0	4/15/81	80.563	A 12/17/80	73.6124	(55,605)	
9	Buy	1.2	FHLMC	10/23/79	8.75	4/15/81	76.704	A 12/17/80	76.4889	(430)	
10	Buy	1.2	FHLMC	10/23/79	9.0	5/01/81	77.1499	A 12/17/80	76.9291	(442)	
11	Buy	1.2	FHLMC	10/23/79	9.25	3/15/78	78.087	A 12/17/80	77.8741	(426)	
12	Buy	1.2	FHLMC	10/23/79	9.5	4/01/81	79.0193	A 12/17/80	78.8149	(409)	
13	Sell	4.8	FHLMC	10/23/79	8.0	5/15/81	73.8655	A 12/17/80	73.6124	2,025	
										A net gain =	21,961
										C + A net, net gain	1,881
										Fees	(1,420)
										Net profit to client	461

1979
RMC ASSOCIATES
(Ellison C. Morgan (31.43 percent))

GREGORY GOVERNMENT SECURITIES ACCOUNT NUMBER 127

Contract number	*ECM buy/sell*	*Amount*	*Type*	*Trade date*	*Percent*	*Settle date*	*Settle price*	*Disposition date*	*Disposition price*	*Gain/(loss) (ECM share)*	
1	Buy	14.0	GNMA	9/28/79	7.5	3/10/81	79.169	C 10/09/79	76.729	($107,360)	
2	Buy	7.0	GNMA	9/28/79	8.25	3/01/81	83.281	C 10/09/79	80.744	(55,814)	
3	Buy	7.0	GNMA	9/28/79	9.0	3/30/81	86.678	C 10/09/79	83.125	(56,166)	($219,340)
4	Sell	7.0	FHLMC	9/28/79	8.75	3/15/81	84.763	A 2/12/81	72.6893	265,621	
5	Sell	7.0	FHLMC	9/28/79	9.0	4/01/81	85.178	A 2/12/81	73.1436	264,757	
6	Sell	7.0	FHLMC	9/28/79	9.25	2/15/81	86.156	A 2/12/81	74.0681	265,934	
7	Sell	7.0	FHLMC	9/28/79	9.5	3/01/81	87.125	A 2/12/81	74.9890	266,992	
8	Buy	28.0	FHLMC	10/09/79	8.0	4/15/81	79.219	A 2/12/81	69.9127	(818,954)	
9	Buy	7.0	FHLMC	10/22/79	8.75	4/15/81	78.2804	A 2/12/81	72.6893	(123,004)	
10	Buy	7.0	FHLMC	10/22/79	9.0	5/01/81	78.7205	A 2/12/81	73.1436	(122,692)	
11	Buy	7.0	FHLMC	10/22/79	9.25	3/15/81	79.6658	A 2/12/81	74.0681	(123,149)	
12	Buy	7.0	FHLMC	10/22/79	9.5	4/01/81	80.6065	A 2/12/81	74.3830	(123,585)	
13	Sell	28.0	FHLMC	10/22/79	8.0	5/15/81	75.3992	A 2/12/81	69.9127	482,812	
										A net gain =	234,732
										C + A net, net gain	15,392
										Fees	(11,031)
										Net profit to client	4,361

1979

JAMES N. LEINBACH AND MARY ALICE LEINBACH

GREGORY GOVERNMENT SECURITIES ACCOUNT NUMBER 137

Contract number	*JNL buy/sell*	*Amount*	*Type*	*Trade date*	*Percent*	*Settle date*	*Settle price*	*Disposition date*	*Disposition price*	*Gain/(loss)*	
1	Buy	4.0	GNMA	10/04/79	7.5	3/10/81	78.464	C 10/19/79	73.6881	($191,036)	
2	Buy	2.0	GNMA	10/04/79	8.25	3/01/81	82.546	C 10/19/79	77.5936	(99,040)	
3	Buy	2.0	GNMA	10/04/79	9.0	3/30/81	84.943	C 10/19/79	79.9534	(99,792)	($389,876)
4	Sell	2.0	FHLMC	10/04/79	8.75	3/15/81	84.025	A 1/27/81	76.9008	142,484	
5	Sell	2.0	FHLMC	10/04/79	9.0	4/01/81	84.443	A 1/27/81	77.3399	142,062	
6	Sell	2.0	FHLMC	10/04/79	9.25	2/15/81	85.416	A 1/27/81	78.2864	142,592	
7	Sell	2.0	FHLMC	10/04/79	9.5	3/01/81	86.365	A 1/27/81	79.2286	142,728	
8	Buy	8.0	FHLMC	10/19/79	8.0	4/15/81	76.1202	A 1/27/81	74.0168	(168,272)	
9	Sell	8.0	FHLMC	10/26/79	8.0	5/15/81	74.9974	A 1/27/81	74.0168	78,448	
10	Buy	2.0	FHLMC	10/26/79	8.75	4/15/81	77.8633	A 1/27/81	76.9008	(19,250)	
11	Buy	2.0	FHLMC	10/26/79	9.0	5/01/81	78.3042	A 1/27/81	77.3399	(19,286)	
12	Buy	2.0	FHLMC	10/26/79	9.25	3/15/81	79.2472	A 1/27/81	78.2864	(19,216)	
13	Buy	2.0	FHLMC	10/26/79	9.5	4/01/81	80.1857	A 1/27/81	79.2286	(19,142)	
										A net gain =	403,148
										C + A net, net gain	13,272
										Fees	(12,660)
										Net profit to client	612

1980

JAMES E. SOCHIN

GREGORY GOVERNMENT SECURITIES ACCOUNT NUMBER 475 AND 476

Contract number	*JES buy/sell*	*Amount*	*Type*	*Trade date*	*Percent*	*Settle date*	*Settle price*		*Disposition date*	*Disposition price*	*Gain/(loss) (JES share)*
14	Buy	8.0	GNMA	6/17/80	9.25	3/15/82	91.8723	A	1/26/82	67.7112	($193,239)
15	Sell	8.0	FHLMC	6/17/80	8.00	4/15/82	85.2462	C	6/20/80	86.5457	(10,396)
16	Sell	8.0	FHLMC	6/20/80	9.25	2/15/82	91.7037	A	1/26/82	66.2112	203,940
17	Sell	4.0	FHLMC	6/20/80	10.00	4/01/82	95.2781	A	1/26/82	69.1602	104,472
18	Sell	4.0	FHLMC	6/20/80	10.25	4/01/82	96.5921	A	1/26/82	70.2305	105,446
19	Buy	4.0	GNMA	6/20/80	10.50	3/01/82	99.4663	C	6/23/80	98.2301	(4,945)
20	Buy	4.0	GNMA	6/20/80	11.25	3/01/82	103.3855	C	6/23/80	102.1184	(5,068)
21	Buy	4.0	GNMA	6/23/80	10.75	5/01/82	99.4664	A	1/26/82	73.8699	(102,386)
22	Buy	4.0	GNMA	6/23/80	11.00	5/01/82	100.7626	A	1/26/82	74.9386	(103,296)
23	Buy	4.0	FHLMC	6/27/80	10.00	3/01/82	91.0065	A	1/26/82	69.1915	(87,260)
24	Buy	4.0	FHLMC	6/27/80	10.25	3/04/82	92.2827	A	1/26/82	78.2618	(88,084)
25	Sell	4.0	GNMA	6/27/80	10.75	4/01/82	96.3289	A	1/26/82	73.9011	89,711
26	Sell	4.0	GNMA	6/27/80	11.00	4/01/82	97.5986	A	1/26/82	74.9698	90,515

1980

JAMES E. SOCHIN (Continued)

GREGORY GOVERNMENT SECURITIES ACCOUNT NUMBER 475 AND 476

Contract number	*JES buy/sell*	*Amount*	*Type*	*Trade date*	*Percent*	*Settle date*	*Settle price*	*Modified settle date*	*Modified settle price*	*Disposition date*	*Disposition price*	*Gain/(loss) (JES share)*
27	Buy	4.8	GMNA	6/18/80	9.25	3/15/82	91.1182	N/A	N/A	C 6/25/80	90.5797	($5,385)
28	Sell	4.8	FHLMC	6/18/80	8.00	4/15/82	84.5104	8/15/83	84.7710	A 1/26/82	59.4013	253,696
29	Buy	4.8	GNMA	6/25/80	8.00	5/15/82	84.9850	9/15/83	85.2768	A 1/26/82	60.4325	(248,443)
30	Sell	2.4	FHLMC	6/25/80	10.00	4/01/82	92.5946	N/A	N/A	C 6/26/80	92.9634	(1,844)
31	Sell	2.4	FHLMC	6/25/80	10.25	4/01/82	93.8851	N/A	N/A	C 6/26/80	94.2571	(1,860)
32	Buy	2.4	GNMA	6/25/80	10.50	3/01/82	96.7360	7/01/83	96.9953	A 1/26/82	72.2121	(123,916)
33	Buy	2.4	GNMA	6/25/80	11.25	3/01/82	100.5866	7/01/83	100.8563	A 1/26/82	75.9531	(124,516)
34	Sell	2.4	FHLMC	6/26/80	10.50	2/01/82	96.1113	6/01/83	96.3394	A 1/26/82	71.1809	125,792
35	Sell	2.4	FHLMC	6/26/80	11.25	2/01/82	99.9714	6/01/83	100.2099	A 1/26/82	74.9219	126,440
36	Sell	4.8	FHLMC	6/26/80	10.75	4/10/82	96.8381	8/10/83	97.1323	A 1/26/82	71.9106	252,216
37	Buy	4.8	GNMA	6/26/80	11.50	3/10/82	102.2525	N/A	N/A	C 6/27/80	100.5140	(17,385)
38	Buy	4.8	GNMA	6/27/80	10.75	5/10/82	96.1418	9/10/83	96.4672	A 1/26/82	72.9418	(235,254)
39	Sell	4.8	FHLMC	6/27/80	11.00	4/20/82	96.4144	8/20/83	96.7120	A 1/26/82	73.1434	235,685
40	Buy	4.8	GNMA	6/27/80	11.75	3/20/82	101.7782	7/20/83	102.0553	A 1/26/82	78.4774	(234,779)
41	Buy	4.8	GNMA	6/30/80	11.00	5/20/82	96.2725	9/20/83	96.6013	A 1/26/82	74.1746	(224,267)
42	Sell	4.8	FHLMC	6/30/80	11.75	2/20/82	99.6082	6/20/83	99.8541	A 1/26/82	77.4462	224,079
											A net gain =	45,502
											C + A net	(1,381)
											Fees	(3,092)
											Net to client	(4,473)

1981

JAMES E. SOCHIN

GREGORY GOVERNMENT SECURITIES ACCOUNT NUMBER 1293

Contract number	JES buy/sell	Amount	Type	Trade date	Percent	Settle date	Settle price	Disposition date	Disposition price	Gain/(loss) (JES share)
43	Sell	2.5	FHLMC	3/31/81	8.25	4/01/83	72.1670	A 1/28/83	78.2089	($48,335)
44	Sell	2.5	FHLMC	3/31/81	8.50	4/01/83	73.1076	A 1/28/83	79.4524	(50,758)
45	Buy	2.5	GNMA	3/31/81	9.00	3/01/83	76.0284	C 4/02/81	75.5986	(3,438)
46	Buy	2.5	GNMA	3/31/81	10.50	3/01/83	82.5329	C 4/02/81	82.0815	(3,611)
47	Buy	2.5	FHLMC	4/02/81	8.25	5/01/83	72.2407	A 1/28/83	78.7089	51,746
48	Buy	2.5	FHLMC	4/02/81	8.50	5/01/83	73.1787	A 1/28/83	79.9524	54,189
49	Buy	2.5	FHLMC	4/08/81	9.00	3/01/83	73.2064	P 4/09/81	73.6015	3,161
50	Buy	2.5	FHLMC	4/08/81	9.25	3/01/83	74.1241	P 4/09/81	74.5214	3,179
51	Sell	2.5	GNMA	4/08/81	9.50	4/01/83	75.5695	P 4/09/81	75.9691	(3,197)
52	Sell	2.5	GNMA	4/08/81	10.50	4/01/83	80.1516	P 4/09/81	80.5668	(3,322)
53	Sell	2.5	GNMA	4/09/81	7.50	3/10/83	68.2401	A 1/28/83	75.5144	(58,194)
54	Sell	1.25	GNMA	4/09/81	8.25	3/20/83	71.9577	A 1/28/83	79.2401	(29,130)
55	Sell	1.25	GNMA	4/09/81	9.00	3/30/83	74.2777	A 1/28/83	83.0259	(34,993)

Continued . . .

1981

JAMES E. SOCHIN continued

GREGORY GOVERNMENT SECURITIES ACCOUNT NUMBER 1293

Contract number	*JES buy/sell*	*Amount*	*Type*	*Trade date*	*Percent*	*Settle date*	*Settle price*	*Disposition date*	*Disposition price*	*Gain/(loss) (JES share)*	
56	Buy	1.25	FHLMC	4/09/81	8.75	3/15/83	73.2898	C 4/10/81	72.2486	(4,165)	
57	Buy	1.25	FHLMC	4/09/81	9.00	4/05/83	73.7465	C 4/10/81	72.7088	(4,151)	
58	Buy	1.25	FHLMC	4/09/81	9.25	2/15/83	74.6672	C 4/10/81	73.6237	(4,174)	
59	Buy	1.25	FHLMC	4/09/81	9.50	3/01/83	75.5843	C 4/10/81	74.5350	(4,197)	
60	Buy	2.5	GNMA	4/10/81	7.50	4/10/83	67.7494	A 1/28/83	76.0144	66,120	
61	Buy	1.25	GNMA	4/10/81	8.25	4/20/83	71.4289	A 1/28/83	79.7401	33,245	
62	Buy	1.25	GNMA	4/10/81	9.00	4/30/83	73.7400	A 1/28/83	83.5259	39,143	
63	Buy	5.0	FHLMC	4/10/81	8.00	4/08/83	69.0184	A 1/28/83	77.4660	135,162	
64	Sell	5.0	GNMA	4/10/81	9.25	3/08/83	74.1549	C 4/13/81	75.0152	(13,768)	
65	Sell	5.0	FHLMC	4/13/81	8.00	2/08/83	69.3536	A 1/28/83	76.9660	(121,798)	
										A net gain =	$36,397
										C + A + P net	(1,283)
										Fees	(2,739)
										Net to client	(4,022)

1980

JAMES N. LEINBACH AND MARY ALICE LEINBACH

GREGORY GOVERNMENT SECURITIES ACCOUNT NUMBER 137

Contract number	*JNL buy/sell*	*Amount*	*Type*	*Trade date*	*Percent*	*Settle date*	*Settle price*	*Disposition date*	*Disposition price*	*Gain/(loss)*	
14	Sell	12.0	FHLMC	6/19/80	8.0	4/15/82	85.7763	A 1/25/82	62.0353	$2,848,920	
15	Buy	12.0	GNMA	6/19/80	9.25	3/15/82	92.4154	C 6/25/80	90.5797	(220,284)	
16	Buy	12.0	GNMA	6/25/80	8.0	5/15/82	85.4850	A 1/25/82	63.5353	(2,633,964)	
17	Sell	6.0	FHLMC	6/25/80	10.00	4/01/82	92.5946	C 6/26/80	93.2964	(42,108)	
18	Sell	6.0	FHLMC	6/25/80	10.25	4/01/82	93.8851	C 6/26/80	94.5931	(42,480)	
19	Buy	6.0	GNMA	6/25/80	10.50	3/01/82	96.7360	A 1/25/82	73.1644	(1,414,296)	
20	Buy	6.0	GNMA	6/25/80	11.25	3/01/82	100.5866	C 12/11/80	86.4730	(169,363)	
								A 1/25/82	76.3791	(1,161,960)	
21	Sell	6.0	FHLMC	6/26/80	9.50	2/01/82	90.7602	A 1/25/82	67.3718	1,403,304	
22	Sell	6.0	FHLMC	6/26/80	10.75	2/01/82	97.2423	A 1/25/82	72.7368	1,470,330	
23	Sell	6.0	GNMA	6/27/80	10.50	4/01/82	95.6225	A 1/25/82	73.1331	1,349,364	
24	Sell	6.0	GNMA	6/27/80	11.25	4/01/82	99.4456	A 1/25/82	76.3478	(1,385,868)	
25	Buy	6.0	FHLMC	6/27/80	9.50	3/01/82	88.9952	A 1/25/82	67.3406	(1,299,276)	
26	Buy	6.0	FHLMC	6/27/80	10.75	3/01/82	95.3994	A 1/25/82	72.7056	(1,361,628)	
27	Buy	1.2	GNMA	12/12/80	11.25	2/01/82	86.5043	A 1/25/82	72.7056	(121,128)	
										A net gain =	$465,534
										C + A net	(8,701)
										Fees	(20,380)
										Net to client	(29,081)

1981

JAMES N. LEINBACH AND MARY ALICE LEINBACH

GREGORY GOVERNMENT SECURITIES ACCOUNT NUMBER 137

Contract number	*JNL buy/sell*	*Amount*	*Type*	*Trade date*	*Percent*	*Settle date*	*Settle price*		*Disposition date*	*Disposition price*	*Gain/(loss)*
28	Sell	8.0	FHLMC	3/18/81	8.25	4/01/82	74.9370	A	1/07/83	79.1865	($339,960)
29	Sell	8.0	FHLMC	3/18/81	8.50	4/01/83	75.8937	A	1/07/83	80.4400	(363,704)
30	Buy	8.0	GNMA	3/18/81	9.0	3/01/83	78.8198	C	3/20/81	77.6006	(97,536)
31	Buy	8.0	GNMA	3/18/81	10.50	3/01/83	85.4630	C	3/20/81	84.1835	(102,360)
32	Buy	8.0	FHLMC	3/20/81	8.25	5/01/83	74.2269	A	1/07/83	79.6865	436,768
33	Buy	8.0	FHLMC	3/20/81	8.50	5/01/83	75.1765	A	1/07/83	88.9400	461,080
34	Buy	8.0	GNMA	3/26/81	7.50	3/10/83	69.3202	A	1/07/83	76.9090	607,104
35	Buy	4.0	GNMA	3/26/81	8.25	3/20/83	73.0601	A	1/07/83	80.7177	306,304
36	Buy	4.0	GNMA	3/26/81	9.00	3/30/83	75.3850	A	1/07/83	84.5343	365,972
37	Sell	4.0	FHLMC	3/26/81	8.75	3/15/83	73.3992	C	3/30/81	73.8267	(17,180)
38	Sell	4.0	FHLMC	3/26/81	9.00	4/05/83	73.8538	C	3/30/81	74.2818	(17,120)
39	Sell	4.0	FHLMC	3/26/81	9.25	2/15/83	74.7779	C	3/30/81	75.2082	(17,212)
40	Sell	4.0	FHLMC	3/26/81	9.50	3/01/83	75.6984	C	3/30/81	76.1311	(17,308)
41	Sell	8.0	GNMA	3/30/81	7.50	4/10/83	69.2290	A	1/07/83	76.4090	(574,400)
42	Sell	4.0	GNMA	3/30/81	8.25	4/20/83	72.9846	A	1/07/83	80.2177	(289,324)
43	Sell	4.0	GNMA	3/30/81	9.00	4/30/83	75.3130	A	1/07/83	84.0343	(348,852)
44	Buy	8.0	GNMA	3/30/81	9.50	3/01/83	77.6285	P	4/02/81	77.4455	(14,640)

Continued . . .

1981

JAMES N. LEINBACH AND MARY ALICE LEINBACH (Continued)

GREGORY GOVERNMENT SECURITIES ACCOUNT NUMBER 137

Contract number	*JNL buy/sell*	*Amount*	*Type*	*Trade date*	*Percent*	*Settle date*	*Settle price*	*Disposition date*	*Disposition price*	*Gain/(loss)*	
45	Buy	8.0	GNMA	3/30/81	10.50	3/01/83	82.2716	P 4/02/81	82.0815	($15,208)	
46	Sell	8.0	FHLMC	3/30/81	9.00	4/01/83	74.2484	P 4/02/81	74.0674	14,480	
47	Sell	8.0	FHLMC	3/30/81	9.25	4/01/83	75.1747	P 4/02/81	74.9926	14,568	
48	Buy	8.0	FHLMC	4/08/81	9.00	3/01/83	73.2064	P 4/09/81	73.6015	31,608	
49	Buy	8.0	FHLMC	4/08/81	9.25	3/01/83	74.1241	P 4/09/81	74.5214	31,784	
50	Sell	8.0	GNMA	4/08/81	9.50	4/01/83	75.5695	P 4/09/81	75.5691	(31,968)	
51	Sell	8.0	GNMA	4/08/81	10.50	4/01/83	80.1516	P 4/09/81	80.5668	(33,216)	
52	Sell	16.0	GNMA	4/10/81	9.25	3/08/83	74.1549	A 1/07/83	85.0065	(1,736,256)	
53	Buy	16.0	FHLMC	4/10/81	8.00	4/08/83	69.0184	C 4/13/81	68.2503	(122,896)	
54	Buy	16.0	GNMA	4/13/81	9.25	2/04/83	73.8634	A 1/07/83	85.5065	1,862,896	
55	Buy	8.0	FHLMC	4/13/81	9.00	3/01/83	71.9218	P 4/14/81	73.3502	114,272	
56	Buy	8.0	FHLMC	4/13/81	9.25	3/01/83	72.8322	P 4/14/81	74.2687	114,920	
57	Sell	8.0	GNMA	4/13/81	9.50	4/01/83	74.2704	P 4/14/81	75.7149	(115,560)	
58	Sell	8.0	GNMA	4/13/81	10.50	4/01/83	78.8013	P 4/14/81	80.3027	(120,112)	
										A net gain =	$387,628
										C + A + P net	(13,056)
										Fees	(28,660)
										Net to client	(41,716)

1980

ELLISON C. MORGAN

GREGORY GOVERNMENT SECURITIES ACCOUNT NUMBER 127

Contract number	*ECM buy/sell*	*Amount*	*Type*	*Trade date*	*Percent*	*Settle date*	*Settle price*		*Disposition date*	*Disposition price*	*Gain/(loss) (ECM share)*
14	Sell	15.0	FHLMC	6/17/80	8.00	4/15/82	85.5625	C	6/20/80	86.5457	($147,480)
15	Buy	15.0	GNMA	6/17/80	9.25	3/15/82	92.1964	A	2/08/82	65.2136	(4,047,420)
16	Sell	15.0	FHLMC	6/20/80	9.25	2/15/82	91.7037	A	2/08/82	63.7136	4,198,515
17	Sell	7.5	FHLMC	6/20/80	10.00	4/01/82	95.2781	A	2/08/82	66.9439	2,125,065
18	Sell	7.5	FHLMC	6/20/80	10.25	4/01/82	96.5921	A	2/08/82	68.1494	2,133,202
19	Buy	7.5	GNMA	6/20/80	10.50	3/01/82	99.4663	C	6/23/80	97.8938	(117,937)
20	Buy	7.5	GNMA	6/20/80	11.25	3/01/82	103.3855	C	6/23/80	101.7737	(120,885)
21	Buy	7.5	GNMA	6/23/80	10.75	5/01/82	99.1273	A	2/08/82	72.0709	(2,029,230)
22	Buy	7.5	GNMA	6/23/80	11.00	5/01/82	100.4206	A	2/08/82	73.2864	(2,035,065)
23	Buy	7.5	GNMA	6/27/80	10.00	3/01/82	92.3731	A	2/08/82	68.0064	(1,827,502)
24	Buy	7.5	GNMA	6/27/80	10.25	3/01/82	93.6522	A	2/08/82	69.2119	(1,833,022)
25	Sell	7.5	FHLMC	6/27/80	10.75	4/01/82	95.6418	A	2/08/82	71.0709	1,842,817
26	Sell	7.5	FHLMC	6/27/80	11.00	4/01/82	96.9144	A	2/08/82	72.2864	1,847,100

A net gain =	$374,460
C + A net	(11,842)
Fees	(13,900)
Net to client	(25,742)

Sochin was a one-sixth participant in GGS's account number 112 which was in the name of Harsh Associates. GGS's transcript of the activity in the account with respect to the 1979 investment is as shown in table on page 981.

The transcript of the Harsh Associates account, in which Sochin was a one-sixth participant, purportedly indicates that for a deposit of $12,000 Harsh Associates received an initial portfolio containing forward contracts 1 to 7 (all dated September 18, 1979) of which the first three represented agreements by Harsh to buy from GGS Ginnie Maes having a total value of $4,800,000 and the last four represented agreements by Harsh to sell to GGS Freddie Macs having a total value of $4,800,000. Sixteen days later, on October 4, 1979, the contracts to buy Ginnie Maes were canceled and the contracts to sell $4,800,000 in Freddie Macs as represented by contracts 4 to 7 were offset by a contract to buy from GGS Freddie Macs in the amount of $4,800,000. On October 23, 1979, Harsh Associates' positions in the buy and sell contracts 4 to 8 were locked down by contract numbers 9 to 13. For his proportionate deposit of $2,000 Sochin claimed an ordinary loss from the October 4 cancellation in the amount of $20,080.[10]

On February 12, 1981, both the contracts to buy and the contracts to sell Freddie Macs (4 to 13) were purportedly disposed of at a net long-term capital gain to Sochin of $21,961 by an assignment to RST. The assignment was executed for Sochin and the other members of Harsh Associates by GIM under its power of attorney.

Morgan was one of six participants in GGS's account number 127. His interest in the account, however, was 31.43 percent. The account was in the name of RMC Associates. The transcript of account number 127 reflects the activity shown in the table on page 983 with respect to the 1979 investment.

The transcript of RMC Associates' account purportedly indicates that for their $70,000 deposit they received an initial portfolio containing forward contracts 1 to 7 (all dated September 28, 1979), of which the first three represented agreements by them to buy from GGS Ginnie Maes having a total value of $28 million, and the last

[10]The record does not contain an explanation for the difference between this figure and the figures used on the return and the statutory notice, both of which reflect a loss of $20,621.

four represented agreements by them to sell to GGS Freddie Macs having a total value of $28 million. Eleven days later, on October 9, 1979, the contracts to buy Ginnie Maes were canceled by GGS and the $28 million in Freddie Macs which were included in sell contracts 4 to 7 were offset by contract 8 to buy from GGS Freddie Macs having a total value of $28 million. On October 22, 1979, RMC Associates' position in contracts 4 to 8 to buy and sell Freddie Macs was locked down by contracts 9 to 13. For his proportionate deposit of $22,000, Morgan claimed an ordinary loss from the October 9 cancellation in the amount of $219,340.[11]

On February 12, 1981, both the contracts to buy and the contracts to sell the Freddie Macs (4 to 13) were all purportedly disposed of at a net long-term capital gain to Morgan of $234,732 by an assignment to RST. The assignment was executed for Morgan and the other members of RMC Associates by GIM under his power of attorney.

Leinbach's account number with GGS was 137 and the transcript of the activity in his account with respect to the 1979 investment is as shown in the table on page 985.

The transcript of Leinbach's account purportedly indicates that for his deposit of $20,000 he received an initial portfolio containing forward contracts 1 to 7 (all dated October 4, 1979), of which the first three represented agreements by him to buy from GGS Ginnie Maes having a total value of $8 million, and the last four represented agreements by him to sell to GGS Freddie Macs having a total value of $8 million. Fifteen days later, on October 19,1979, the contracts to buy Ginnie Maes were canceled by GGS at an ordinary loss for Leinbach of $389,876[12] and the contracts to sell Freddie Macs were offset by contract number 8 to buy from GGS Freddie Macs in the total amount of $8 million. On October 26, 1979, his position in the Freddie Macs were locked down by agreements to sell and to buy Freddie Macs in the amount of $8 million. On January 27, 1981, all

[11]The record does not contain an explanation for the difference between this figure and the figures used on the return and the statutory notice, both of which reflect a loss of $224,416.

[12]The record does not contain an explanation for the difference between this figure and the figures used on the return and the statutory notice, both of which reflect a loss of $394,676.

of the Freddie Mac contracts were disposed of at a net long-term capital gain to Leinbach of $403,148 by assignment to RST. The assignment was executed for Leinbach by GIM under his power of attorney.

Brown did not participate in the program after 1979, and Morgan did not participate in the program after 1980. Transcripts of Sochin's and Leinbach's accounts for the years 1980 and 1981 as well as a transcript of Morgan's account for 1980 are set out in the tables on pages 986-992.

The deposits made by Brown, Sochin (through Harsh Associates), Morgan (through RMC Associates), and Leinbach during 1979 were refunded to them before the end of 1979. The first 49 participants in the Gregory program generally were accorded the same treatment as these petitioners. In other words, in spite of any inconsistency in their interest forecasts, these first participants each received a portfolio of contracts (many of which contained the same contracts as the portfolios received by other participants); shortly after receipt, the loss leg of each of their contract portfolios was canceled, generating the putative losses in issue; their deposits were refunded in full; their gain legs (which were locked in) were carried on GGS' books for a period generally exceeding 16 months; and then their gain legs were assigned, which generated a credit to each participant's account that was set off against the loss (debit) generated by the earlier cancellation. Those participants who followed with GGS accounts numbered 150 and after were accorded the same treatment as the first participants except that they did not receive refunds of their deposits.[13] The refunds given by Gregory to the first 49 participants obviously served as some inducement to others to participate in his program.

All assignments made during 1980 and through November 1981 were to RST, a partnership whose members, Campbell Richardson, Stephen Shepard, and David Tangvald, were associates of Gregory. The assignments made thereafter were to Northwest Investment Group, Inc. (NIG), a Nevada corporation of which Patricia Buescher, a niece of Mr. Gregory and an employee of GGS, was the principal stockholder and officer. Lyle Adams, another employee of GGS, was also an officer

[13] In or about November of 1979, full refunds of deposits ceased.

of NIG. GGS mailed the assignment documents to NIG at a mail drop established by NIG in Nevada; the documents were forwarded from there to Adams at his Portland residence.

GGS paid RST and NIG $100 for each assignment without regard to the amount of the contract. The assignment fee in each case was charged to the participant's account. The contracts were subsequently reassigned by RST and NIG to GGS at the same price as that used in the original assignment by the participant. As a result, neither RST nor NIG realized any income from the acquisition or the disposition of the contracts. In this connection, their income was limited to the $100 fees paid by GGS and charged to the participants. Furthermore, both the assignments to RST and NIG, as well as the reassignments by them to GGS, were handled by offsetting accounting entries of receiveables and payables. In other words, other than the assignment fees for $100, no funds were exchanged with respect to the contracts at any time between the participants and RST or NIG on the original assignment or between RST or NIG and GGS on the reassignments.

After the reassignment of an investor's contracts by RST or NIG to GGS, the payable due from the investor as a result of the cancellation of his loss position was due to GGS. At the same time, the receivable in approximately the same amount due the investor as a result of the assignment of his gain position was due from GGS. At this point, the circle was completed and neither the investor, nor his assignee on the gain position (RST or NIG), nor GGS had realized any actual gain or loss on the contracts. The relatively minor net profits or net losses reflected by some of the transcripts of its accounts with petitioners were generated by GGS through "adjustments" to the cancellation prices and/or the assignment prices or, at times, by the failure of GGS to charge full transaction fees in accordance with the client agreements.

No Ginnie Maes or Freddie Macs were ever bought or sold with respect to any of the forward contracts to buy or sell such securities executed by GGS as one party, and executed by or for petitioners Brown, Sochin, Morgan, or Leinbach as the other party. In fact, the record does not contain any evidence that any Ginnie Maes or any Freddie Macs were ever bought, sold, accepted, or delivered under any forward contract executed by GGS with any investor during the years 1979, 1980, and 1981.[14] Instead, all loss positions were canceled

[14] There is some evidence that a single such transaction was entered into with respect to litigation pending in another court after 1981.

before settlement dates and all gain positions were assigned to RST or NIG and reassigned to GGS before such dates. Apparently GGS also never had any inventory of either Ginnie Maes or Freddie Macs because, as Gregory testified, if GGS had ever been called upon for delivery it would have had to go into the market and try to make the necessary purchase.

In at least two instances, a Ginnie Mae described in and covered by one of the alleged forward contracts involved in this case was a rate (11.25 percent and 11.75 percent) at which no Ginnie Mae had ever been issued up to the date of trial.

The use of a cancellation to close, dispose of, or settle a forward contract is not a common practice by dealers in such contracts. For the most part, cancellations are used by such dealers only to correct errors.

Petitioner Dennis S. Brown is the sole stockholder and principal officer of an employment agency which he started in 1968. Prior to his investment in Gregory Government Securities, he had speculated in interest-rate futures offered by Merrill Lynch. He learned about Mr. Gregory from his accountant in October of 1979, and shortly thereafter attended a meeting with Mr. Gregory with his accountant and several other clients of his accountant.

On or about October 4, 1979, Mr. Brown deposited $10,000 with GGS. The deposit was refunded to him before the end of 1979. He was advised that before the end of 1979 he had realized an ordinary loss from GGS in the amount of $106,160 which he deducted on his 1979 return. He understood that in 1981 he had a long-term capital gain from the assignment of the remainder of his portfolio with GGS in the amount of $106,382 which he reported on his 1981 income tax return.

In 1979, 1980, and 1981, petitioner James E. Sochin was employed by Harsh Investment Corp. as a vice president in charge of its hotel operations division. He first heard about Mr. Gregory through Harold Schnitzer, who was the owner of Harsh Investment Corp. through a meeting arranged by Mr. Schnitzer, Mr. Sochin attended a conference with Mr. Gregory in which he explained the portfolio structure and how interest rate movements affected security prices. After this meeting and on or about September 18, 1979, Mr. Sochin contributed $2,000 toward the total $12,000 deposited with GGS by Harsh Associates; Sochin and the other Harsh Associates received full re-

funds of their deposits before the end of 1979. He was later advised that he had an ordinary loss in 1979 of $20,621 which he reported on his 1979 income tax return. In 1980, he was advised that he had an ordinary loss on his GGS transactions in the amount of $48,054 and a long-term capital gain in the amount of $21,142, both of which he reported on his 1980 return. In 1981, he deducted an ordinary loss in the amount of $38,785 and reported a long-term capital gain in the amount of $44,804 from his GGS transactions.

At the time of trial, Ellison C. Morgan was 47 years of age. During 1979, 1980, and 1981, he was the president of Resource Management Consultants which designs and markets executive compensation plans, places loans for savings and loan associations, and through a separate company, designs and markets life insurance products through about 50 distributors. From about 1971 through about 1982, he invested regularly and extensively in futures contracts. For example, during this period he bought, sold and otherwise dealt in futures contracts in sugar, cattle, hopps, copper, corn, wheat, Deutsche marks, Swiss francs, bean oil, Canadian dollars, gold, treasury bills, and treasury bond. He had also dealt in Ginnie Maes and Freddie Macs.

Mr. Morgan first met Mr. Gregory while he was a partner with Arthur Andersen. They first met professionally when Mr. Gregory did some estate and financial planning for some of Mr. Morgan's clients and partners. Some time later in 1979, Mr. Morgan met on several different occasions with Mr. Gregory in order to learn about the promotion known as Gregory Government Securities. During these conversations and later conversations which he had with his own attorney, Mr. Morgan was made to understand that there was no guarantee against losses in case an investment was made in the program, and there was no guarantee of any gains. He did understand that an investment would result in a tax write-off during the first year of approximately 10 to 1. He also understood that his initial deposit would be returned during the first year.

Mr. Morgan understood that he would simply furnish Mr. Gregory with an interest forecast and that Mr. Gregory would handle all of the necessary transactions through his two corporations. He was later advised that the transactions resulted in an ordinary loss during 1979 in the amount of $224,416, which he claimed on his 1979 income tax return. He also claimed a deduction for investment advice in the

amount of $357. His deposit was also refunded to him before the end of 1979. In 1980, he was advised that he had an ordinary loss from his GGS transactions in the amount of $390,614 which he deducted on his 1980 return. On his 1981 income tax return, he reported a long-term capital gain from GGS transactions in the amount of $234,518, which he understood was the final result of his 1979 portfolio. He was later advised that he had a long-term capital gain in 1982 from his 1980 portfolio, but he did not report the 1982 gain because respondent in the meantime had audited his earlier returns and had disallowed the losses claimed therein.

Petitioner James N. Leinbach is a professional engineer, having received a composite degree in civil, electrical, and mechancial engineering from the University of Portland in 1951. Upon receipt of his engineering degree, he went to work for a construction firm by the name of Slate-Hall as an assistant engineer. In 1961 he became a partner, and by 1979 he owned 50 percent of the firm which was then known as the Fred H. Slate Co. The company is primarily engaged in the construction of highways, but builds some dams. Prior to 1979, Mr. Leinbach had made personal investments in bonds, common stocks, and preferred stocks. Some of his investments were exempt from State income tax.

In or about September of 1979, Mr. Leinbach learned of the GGS program. Shortly thereafter, he and his accountant and his partner attended a meeting with Mr. Gregory. As a result of the meeting, Mr. Leinbach understood that the program involved mortgages secured by the Government and he also understood that there were a number of advantages including the possibility of a profit and a considerable tax loss in the first year.

In 1979, he made a deposit of $20,000 with GGS. The deposit was refunded to him before the end of the year. On his income tax return for 1979, Mr. Leinbach reported income in the amount of $427,681 from his partnership and deducted a loss in the amount of $394,376 on his GGS transactions. On his 1980 income tax return, Mr. Leinbach reported income from the partnership and other sources of $536,507 and deducted an ordinary loss from GGS transactions in the amount $482,245. On his income tax return for 1981, Mr. Leinbach reported a long-term capital gain from the GGS transactions in the amount of $401,464 and an ordinary loss from the same transactions in the amount of $401,412. On his 1982 tax return, Mr. Lein-

bach reported a long-term capital gain from GGS transactions in the amount of $461,444.[15]

OPINION

1. Losses on Forward Contracts

The central issue in these cases is whether the losses claimed by petitioners are bona fide or whether they are based upon an elaborate sham. Respondent contends that the losses were generated in form without any substance, that the underlying transactions were fictitious, and that such transactions existed only within the GGS computer. On the other hand petitioners contend that the losses were genuine and were the result of bona fide transactions entered into for profit under section 165(c)(2) and are clearly allowable under section 108 of the Tax Reform Act of 1984, Pub. L. 98-369, 98 Stat. 680, or the standard laid down in *Smith v. Commissioner*, 78 T.C. 350 (1982).

Section 165(a) allows a deduction for a loss sustained during the taxable year that is not compensated for by insurance or otherwise. In the case of individuals, however, the deduction is limited to losses incurred in a trade or business, in a transaction entered into for profit, or as the result of a casualty or theft. Sec. 165(c). In any event, to be deductible, the claimed loss must be the result of a bona fide transaction, and substance, not mere form, shall be the determining factor. Sec. 1.165-1(b), Income Tax Regs. See *Gregory v. Helvering*, 293 U.S. 465 (1935).

Respondent's determination that the underlying transactions are not bona fide is presumptively correct; and petitioners have the burden of proof. *Welch v. Helvering*, 290 U.S. 111, 115(1933); *New Colonial Ice Co. v. Helvering*, 292 U.S. 435, 440(1934); Rule 142(a).

A careful review of the voluminous record leads us to the inescapable conclusion that petitioners have failed to establish that the transactions leading to their alleged losses were bona fide. In fact, from the record as a whole, we are satisfied that petitioners have failed to establish that

[15] An amended return was filed for 1981 and 1982 as a protective claim for refund of the reported gain because the Commissioner on audit disallowed the GGS losses previously reported.

the entire program from which the losses allegedly arose did not exist solely to provide tax benefits for its investors.

All of the forward contracts promoted by Mr. Gregory were between GGS, as one party, and one petitioner or some other participant, as the other party. Furthermore, each petitioner as well as all other participants executed a power of attorney which authorized GGS and/or GIM to execute and perform any act for the investor with respect to the contracts that GGS and GIM deemed expedient and at a price determined by GGS and adjusted for any reason which GGS considered appropriate. In addition, an ultimate profit obviously could be, and at times was to a nominal extent, manipulated by GGS merely by foregoing a part of the fees cited in the disclosure memorandum or by utilizing its pricing formula.

These cases are analogous to, if not factually indistinguishable from, the situation recently considered by us in *Julien v. Commissioner*, 82 T.C. 492 (1984). In *Julien v. Commissioner, supra*, we disallowed interest deductions on alleged indebtedness incurred to purchase silver bullion in a series of purported cash and carry silver straddles. Having found that the taypayers never actually purchased any silver nor incurred any real indebtedness, we concluded that the underlying transaction was a factual sham and served no economic purpose beyond generating a tax deduction for interest. Commenting on the lack of risk due to the fixed nature of the straddles involved in *Julien*, we stated at page 508:

> It seems self-evident that, in any commodity straddle, a legitimate investor must have some potential of making money as a result of various market forces and, by the same token, be a[t] risk of losing money. One commentator has said that "A commodity straddle is held in the expectation of profiting from a change in the 'spread' or 'premium', the difference in price between two futures contracts. While the price movements of the two contracts will have some relationship to each other, as the prices will be affected by similar economic conditions, neither in theory nor in practice are the fluctuations identical." See R. Dailey, "Commodity Straddles in Retrospect: Federal Income Tax Considerations," 47 Brooklyn L. Rev. 321 (Winter, 1981). Presumably, fluctuations would also occur in a case where the investor holds silver bullion against a forward contract, if the end result were not, as here, prearranged.

In *Falsetti v. Commissioner*, 85 T.C. 332 (1985), we found that an alleged sale was a "sham in substance" which we defined as being "the expedient of drawing up papers to characterize transactions contrary to objective economic realities and which have no economic significance beyond expected tax benefits."

The facts before us are also somewhat similar to those described in *United States v. Winograd*, 656 F.2d 279, 281 (7th Cir. 1981), affirming defendant's conviction under section 7206(2) of conspiring to impair the collection of income taxes by claiming losses on tax straddles in futures contracts in Mexican pesos which were not entered into through bona fide trades or open bids on an established market but instead were prearranged, uncompetitive trades between various employees of one of the principals involved. See also *United States v. Turkish*, 623 F.2d 769 (2d Cir. 1980); *United States v. Siegel*, 472 F. Supp. 440 (N.D. Ill. 1979). The conclusion that the disputed transactions in the cases before us are not bona fide is even more appropriate in view of our finding that GGS was not only a party to each of the forward contracts but also in most instances executed, canceled, and assigned the contracts under powers of attorney for the other parties. Furthermore, the contracts were executed, canceled, and assigned at prices determined solely by GGS, and the only third parties to any of the transactions (RST and NIG) were closely associated with Mr. Gregory through business or otherwise.

We conclude, therefore, that the losses claimed by petitioners are not allowable because the disputed transactions constituted factual shams which were inspired, designed, and executed by Mr. Gregory and the two corporations controlled by him for the sole purpose of attempting to achieve tax losses for their investors.[18]

This conclusion is not altered by our decision in *Smith v. Commissioner, supra*, or by section 108 of the Tax Reform Act of 1984, because they do not apply to alleged straddles which are in fact fake or fictitious. *Miller v. Commissioner*, 84 T.C. 827 (1985); *Forseth v. Commissioner*, 85 T.C. 127 (1985); *Magin v. Commissioner*, T.C. Memo. 1985-304.

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[18] In view of our finding with respect to the sham issue, we need not consider the other contentions advanced by respondent with respect to the losses.

2. Fees Paid With Respect to Forward Contracts

Fees paid by petitioners to GGS were paid so that they could participate in Gregory's program. Inasmuch as we have found that the program was operated solely to provide tax deductions for its participants, the fees constituted payments to purchase such deductions and as such are, at best, personal expenditures which are not deductible under section 162 or section 212. *Zmuda v. Commissioner,* 79 T.C. 714 (1982), affd. 731 F.2d 1417 (9th Cir. 1984); *Houchins v. Commissioner,* 79 T.C. 570 (1982). See also *Falsetti v. Commissioner,* 85 T.C. 332 (1985).

3. Additions to Tax Under Section 6653(a)

Respondent determined that an addition to tax is due from petitioners Ellison C. and Linda Morgan for negligence under section 6653(a). In view of our finding hereinbefore that the underlying transactions were in fact shams, and in view of our subsequent finding that peitioner Ellison C. Morgan knew or should have known at the time that they were shams, it is apparent that he ignored applicable law and regulations in the preparation of his returns. Consequently, respondent's determination that additions to tax are due from Ellison C. Morgan under section 6653(a) is sustained.

4. Damages Under Section 6673

Finally, we turn to respondent's request that damages be imposed against petitioners in each of these cases under section 6673. With respect to this issue and from the record as a whole, we are satisfied that, in spite of their protestations to the contrary, petitioners Dennis S. Brown, James E. Sochin, Ellison C. Morgan, and James N. Leinbach were mature, well-educated, and well-read individuals who were sufficiently knowledgeable and sophisticated with respect to business and tax matters to have known, and actually did know, at the time the disputed transactions were entered into, that the transactions were "too good" to be real and therefore were shams. However, transactions involving forward contracts and especially forward

contracts entered into with respect to Ginnie Maes and Freddie Macs are extremely complicated and, during the years under consideration, were relatively new. Furthermore, from the time the petitions were filed in these cases up to and after the date of trial, the law with respect to tax straddles was uncertain. See *Miller v. Commissioner,* 84 T.C. 827 (1985); *Forseth v. Commissioner,* 85 T.C. 127 (1985); and *Julien v. Commissioner,* 82 T.C. 492 (1984). Consequently, we are reluctant to conclude that petitioners were also aware that tax claims stemming from their transactions with Gregory and his associates might constitute a basis for the imposition of damages under section 6673, although the Supreme Court had held for many years that claims based upon unreal and sham transactions were not recognizable for tax purposes. See *Gregory v. Helvering,* 293 U.S. 465 (1935); *Higgins v. Smith,* 308 U.S. 473 (1940); and *Knetch v. Commissioner,* 364 U.S. 361 (1960), affg. 272 F.2d 200 (9th Cir. 1959). We hereby serve notice, however, that henceforth we will have no such reluctance with respect to petitioners who file petitions or maintain positions based upon transactions which they knew or reasonably should have known to be factual shams.

We feel that such action is warranted because Congress is concerned with the substantial increase in the number of petitions pending before the Tax Court and especially those petitions based upon frivolous or groundless claims. The concern of Congress in this connection is apparent from the Conference report on the consideration of section 6621(d)(4) dealing with increased interest on substantial underpayments attributable to tax motivated transactions. There it is stated:

> The conferees note that a number of the provisions of recent legislation have been designed, in whole or in part, to deal with the Tax Court backlog. Examples of these provisions are the increased damages assessable for instituting or maintaining Tax Court proceedings primarily for delay or that are frivolous or groundless (sec. 6673), the adjustment of interest rates (sec. 6621), the valuation overstatement and substantial understatement penalties (secs. 6659 and 6661), and the tax straddle rules (secs. 1092 and 1256).
>
> * * *
>
> The conferees believe that, with this amendment, the Congress has given the Tax Court sufficient tools to manage its docket, and that the responsibility

for effectively managing that docket and reducing the backlog now lies with the Tax Court. The positive response that the Court has made to several recent GAO recommendations is encouraging and the conferees expect the Court to implement swiftly these and other appropriate management initiatives. The conferees also note favorably the steps the Court has begun to take in consolidating similar tax shelter cases and dispensing with lengthy opinions in routine tax protester cases. The court should take further action in these two areas, as well as to assert, without hesitancy in appropriate instances, the penalties that the Congress has provided.

[H. Rept. 98-861 (Conf.) (1984), 1984-3 C.B. (Vol. 2) 1, 239.]

Our own concern for the continuing increase in the number of petitions based upon frivolous or groundless claims has been clearly expressed in such opinions as *Sydnes v. Commissioner*, 74 T.C. 864, 872 (1980), where we stated:

While in the past we have been reluctant to impose damages in cases involving persons other than those who were merely protesting the Federal tax laws, we think the imposition of damages in the circumstances here is fully warranted. Moreover, since the statute does not restrict us to those cases in which a party has requested us to impose damages, we think we should do so, on our own motion, where the facts and circumstances so dictate.

Here, the Court and respondent have been required to consider the same issue twice after it has already been decided by this Court and affirmed by the Court of Appeals. Petitioners with more genuine controversies have been delayed while we considered these cases involving the same issue. In these circumstances, the petitioner, an accountant with some knowledge of the Federal tax laws, cannot and has not shown that he, in good faith, has a colorable claim to challenge the Commissioner's determination. Indeed, he knew when he filed the present case with this Court that he had no reasonable expectation of receiving a favorable decision. No reasonably prudent person could have expected this Court to reverse itself in this situation.

In *Oneal v. Commissioner*, 84 T.C. 1235, 1243-1244 (1985), we warned such petitioners as follows:

We have frequently found that cases based upon meritless contentions and stale arguments are burdensome both on this Court and upon society as a

whole. See *Abrams v. Commissioner,* 82 T.C. 403 (1984). The time spent upon this case has delayed other cases of merit which could have provided new precedents to the tax system. Petitioners' brief, much like their abusive tax shelter "investment," was merely a prepackaged, pro forma presentation.

Upon review of this record, we find the petitioners' positions are frivolous and groundless and that this proceeding was instituted and maintained primarily for delay. We admonish other petitioners and their counsel not to maintain frivolous proceedings before this Court or to maintain them primarily for delay.

Again, in *Abrams v. Commissioner,* 82 T.C. 403, 411-412 (1984),[17] we summed up the situation in the following manner:

The Court of Appeals for the Ninth Circuit has, in a summary and decisive manner, awarded double costs in several tax protester cases on its own motion. On July 7, 1982, in *Edwards v. Commissioner,* 680 F.2d 1268, 1271 (9th Cir. 1982), affg. per curiam an unreported decision of this Court, the Court said—

"Meritless appeals of this nature are becoming increasingly burdensome on the federal court system. *We find this appeal frivolous.* Fed. R. App. P. 38, and accordingly award double costs to appellee [the Commissioner of Internal Revenue]. * * * [Citations omitted; emphasis added in 82 T.C.]"

Accord *McCoy v. Commissioner,* 696 F.2d 1234 (9th Cir. 1983), affg. 76 T.C. 1027 (1981); *Barmakian v. Commissioner,* 698 F.2d 1228 (9th Cir. 1982) affg. without published opinion an unreported order and decision of this Court; *Martindale v. Commissioner,* 692 F.2d 764 (9th Cir. 1982), affg. without published opinion an unreported order and decision of this Court.

It is now certain that all Courts will no longer tolerate the filing of frivolous appeals. On June 13, 1983, the Supreme Court, for the first time, invoked the provisions of its rule 49.2, which the Court adopted in 1980, and ordered an appellant to pay damages for bringing a frivolous appeal. In *Tatum, Elmo C. v. Regents of Nebraska-Lincoln* (No. 82-6145), the Court issued the following order: "The motion of respondents for damages is granted and damages are awarded to respondents in the amount of $500.00 pursuant to the Supreme Court Rule 49.2."

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[17] See also *Stafford v. Commissioner,* T.C. Memo. 1983-650, and *Vickers v. Commissioner,* T.C. Memo. 1983-429.

The direction of this nation's highest court is crystal clear—that no court should permit frivolous or groundless appeals, not only in discrimination suits but in any other area of litigation, including Federal income taxation. The language of amended section 6673 is equally clear.
[Fn. refs. omitted.]

Finally, in *Elliot v. Commissioner,* 84 T.C. 227, 248 (1985), we stated that "At some point, the arguments in these highly leveraged tax avoidance (or evasion) schemes must be regarded as 'frivolous or groundless,' [under] section 6673."[18]

Even though the positions maintained by petitioners in these cases may be frivolous and groundless, we decline to impose damages as provided by section 6673 against these petitioners because prior to the publication of this opinion they were not aware that we would consider doing so in factual situations such as theirs. This is not to be construed, however, as any indication that specific notice is required before damages are imposed in a future case because, as held in *Abrams v. Commissioner,* 82 T.C. 403 (1984), in a proper case we can and will impose such damages even on our own motion.

[18] See also *Snyder v. Commissioner,* T.C. Memo. 1985-9, where we concluded, "it is apparent from the overall record * * * that petitioner was a party to an abusive tax shelter. This type of arrangement disparages good tax planning and denigrates both the Congressional purpose inherent in the credits and deductions which we here disallow and our national tax system. Petitioner knew, or reasonably should have known, this when he agreed to participate in this specious stratagem of tax illusion. Petitioner, and those like him, who exchange small cash amounts for large tax deductions because of pie-in-the-sky nonrecourse transactions arranged to jack up basis without underlying economic substance or entrepreneurial risk may become subject to consequences unanticipated by the parties. See *Barnard v. Commissioner,* 731 F.2d 230 (4th Cir. 1984), affg. *Fox v. Commissioner,* 80 T.C. 972 (1983)."

Decisions will be entered under Rule 155.

Reviewed by the Court.

STERRETT, SIMPSON, GOFFE, CHABOT, NIMS, PARKER, WHITAKER, KÖRNER, HAMBLEN, COHEN, CLAPP, JACOBS, WRIGHT, PARR, and WILLIAMS, *JJ.*, agree with this opinion.

WILBUR, *J.*, concurs in the result only.

SWIFT and GERBER, *JJ.*, did not participate in the consideration of this case.

UNITED STATES TAX COURT

JAMES E. SOCHIN	)	
Petitioner.	)	Docket No. 2313-83
v.	)	GREGORY GOVERNMENT SECURITIES, INC. CASE
COMMISSIONER OF INTERNAL REVENUE.	)	
Respondent.	)	

DECISION

Pursuant to the opinion of the court filed December 18, 1985, and incorporating herein the facts recited in the respondent's computation as the findings of the court, it is

ORDERED and DECIDED: that there is a deficiency in income tax for the taxable year 1979 in the amount of $9,402 which amount was paid after the mailing of the notice of deficiency and an overpayment for the year 1979 in the amount of $5,000; and,

That there is a deficiency in income tax for the taxable year 1980 as follows:

Tax liability	$23,595
Tax assessed and paid	4,191
Deficiency to be assessed	$19,404
Tax paid February 9, 1983 (paid after mailing of deficiency notice, but not assessed)	15,535
Unpaid deficiency	$ 3,869

That there is a deficiency in income tax for the taxable year 1981 in the amount of $18,288.

(signed) Perry Shields
Judge.

Entered: December 30, 1986

TEXT OF STATUTE

Section 108 of P.L. 98-369, 98 Stat. 630-631, (Deficit Reduction Act of 1984), *as amended by* sections 2 and 1808(d) of P.L. 99-514, 100 Stat. 2085, (Tax Reform Act of 1986), with effective date of amendments as if included originally in P.L. 98-369 (July 18, 1984)—see secs. 2(b)(1) and 1881 of P.L. 99-514, 100 Stat. at 2095 and 2914.

"Sec. 108 TREATMENT OF CERTAIN LOSSES ON STRADDLES ENTERED INTO BEFORE EFFECTIVE DATE OF ECONOMIC RECOVERY TAX ACT OF 1981.

"(a) GENERAL RULE —For purposes of the Internal Revenue Code of [1986], in the case of any disposition of 1 or more positions

(1) which were entered into before 1982 and form part of a straddle, and

(2) to which the amendments made by title V of such Act do not apply,

any loss from such disposition shall be allowed for the taxable year of the disposition if such [loss is incurred in a trade or business, or if such loss is incurred in a transaction entered into for profit though not connected with a trade or business].

"(b) [LOSS INCURRED IN A TRADE OR BUSINESS —For the purposes of subsection (a), any loss incurred by a commodities dealer in the trading of commodities shall be treated as a loss incurred in a trade or business].

"(c) NET LOSS ALLOWED —If any loss with respect to a position described in paragraphs (1) and (2) of subsection (a) is not allowable as a deduction (after applying subsections (a) and (b)), such loss shall be allowed in determining the gain or loss from dispositions of other positions in the straddle to the extent required to accurately reflect the taxpayer's net gain or loss from all positions in such straddle.

"(d) OTHER RULES —Except as otherwise provided in subsections (a) and (c) and in sections 1233 and 1234 of such Code, the determination of whether there is recognized gain or loss with respect to a position, and the amount and timing of such gain or loss, and the treatment of such gain or loss as long-term or short-term shall be made without regard to whether such position constitutes part of a straddle.

"(e) STRADDLE —For purposes of this section, the term 'straddle' has the meaning given to such term by section 1092(c) of the Internal Revenue Code of [1986] as in effect on the day after the date of the enactment of the Economic Recovery Tax Act of 1981, and shall include a straddle all the positions of which are regulated futures contracts.

"(f) [COMMODITIES DEALER —For purposes of this section, the term 'commodities dealer' means any taxpayer who—

(1) at any time before January 1, 1982, was an individual described in section 1402(i)(2)(B) of the Internal Revenue Code of [1986] (as added by this subtitle), or

(2) was a member of the family (within the meaning of section 704(e)(3) of such Code) of an individual described in paragraph (1) to the extent such member engaged in commodities trading through an organization the members of which consisted solely of—

(A) 1 or more individuals described in paragraph (1), and

(B) 1 or more members of the families (as so defined) of such individuals.]

"(g) REGULATED FUTURES CONTRACTS —For the purposes of this section, the term 'regulated futures contracts' has the meaning given to such term by section 1256(b) of the Internal Revenue Code of [1986] (as in effect before the date of enactment of this Act).

"(h) [SYNDICATES —For purposes of this section, any loss incurred by a person (other than a commodities dealer) with respect to an interest in a syndicate (within the meaning of section 1256(e)(3)(B) of the Internal Revenue Code of [1986]) shall not be considered to be a loss incurred in a trade or business.]"

26 USC 165(a), (b), (c)

Losses.

(a) General rule. There shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise.

(b) Amount of Deduction. For purposes of subsection (a), the basis for determining the amount of the deduction for any loss shall be the adjusted basis provided in section 1011 for determining the loss from the sale or other disposition of property.

(c) Limitation on Losses of Individuals. In the case of an individual, the deduction under subsection (a) shall be limited to

(1) losses incurred in a trade or business;

(2) losses incurred in any transaction entered into for profit, though not connected with a trade or business; and

(3) except as provided in subsection (h), losses of property not connected with a trade or business or a transaction entered into for profit, if such losses arise from fire, storm, shipwreck, or other casualty, or from theft.

CERTIFICATE OF SERVICE

Pursuant to Rules 28.3 and 28.4 of the Rules of the Supreme Court of the United States, this certifies that three copies of the foregoing petition for writ of certiorari were served on:

Mr. Charles Fried
United Stated Solicitor General
Department of Justice
Washington, D.C. 20530;

and that three aditional copies of the petition were served on:

Mr. William F. Nelson
Chief Counsel for the
Internal Revenue Service
1111 Constitution Avenue, N.W.
Room 3026
Washington, D.C. 20224

All parties required to be served have been served. All service was done by mail with postage prepaid on June 9, 1988.

June 9, 1988
Date

Joseph Wetzel
Counsel for petitioner

(2)

No. 87-2026

In the Supreme Court of the United States

OCTOBER TERM, 1988

JAMES E. SOCHIN, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

MEMORANDUM FOR THE RESPONDENT IN OPPOSITION

CHARLES FRIED
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Department of Justice
Washington, D.C. 20530
(202) 633-2217

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COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

MEMORANDUM FOR THE RESPONDENT IN OPPOSITION

Petitioner contends that the courts below erred in finding that purported commodity trades engaged in by petitioner were "shams" that did not generate deductible losses.

1. During the years 1979-1981, petitioner, along with more than 1400 other individuals, participated in a tax shelter program operated by Gregory Investment and Management, Inc. (GIM) and Gregory Government Securities, Inc. (GGS). The program was designed to generate substantial tax losses for the participants by means of a "straddle."[1] The participants purportedly invested in "forward contracts"[2] to buy and sell certificates issued by the Government National Mortgage Association

[1] A "straddle" involves the simultaneous holding of a buy and a sell position in similar commodities.

[2] A "forward contract" is like a futures contract, *i.e.*, an agreement to buy or sell a specific quantity of a commodity at a specified price on a specified future date.

("Ginnie Maes") and the Federal Home Loan Mortgage Corporation ("Freddie Macs"), and the investments purportedly were tailored to the client's own forecast of the movement of interest rates. Under the program, GIM served as a financial adviser to prospective investors, while GGS was the seller or buyer in each transaction. GGS purported to use an elaborate multi-step pricing formula to determine the fees that it would charge under the various contracts that it entered into with its clients, but the formula provided that GGS could make any adjustment that it deemed appropriate. The agreement signed by each client provided that GGS could liquidate any open position or cancel any order whenever it considered it necessary for its protection, without notice to the client. The client also was required to execute a power of attorney in favor of GIM. Pet. App. A4-A5, A23-A24.

The client would give GGS a deposit (which generally was the greater of $10,000 or .125% of the face value of his investments) and furnish GIM with an interest rate forecast. In return, the client would receive a portfolio of forward contracts in Ginnie Maes and Freddie Macs, which GGM and GIS advised could be expected to generate a tax deduction of approximately $10 for each $1 of deposit, regardless of the accuracy of the forecast. This original portfolio constituted a straddle or series of straddles, since 50% of the contracts were to purchase securities (long positions), and 50% were to deliver securities (short positions). Any significant change in the prevailing interest rate would result in a loss position in one "leg" of the straddle and a gain position in the other "leg." When interest rates had moved enough to generate the amount of the desired tax loss, the "loss" positions were cancelled, which purported to create an ordinary loss for the investor in the year of cancellation. Pet. App. A4-A5, A21-A22, A25.

After the cancellation of the loss positions, the straddle was immediately reestablished by providing the client with a position similar to the one that had just been cancelled, thereby "locking in" the gain inherent in the leg that had been retained. After the gain inherent in the client's positions had been deferred for a period generally exceeding 16 months, all positions in the account were purportedly assigned to a third party that was closely associated with GGS: For a flat fee of $100 per assignment, for which GGS was reimbursed by its clients, the third party immediately assigned the contracts back to GGS at the same price, thus completing the circle. The amount that had been "owed" by each client to GGS with respect to the initial cancellation of the client's "loss" positions was offset against the approximately equal amount "owed" by GGS to the client as a result of the assignment of the gain positions. The client then paid GGS a fee for administering the program. No client ever actually purchased or sold Ginnie Maes or Freddie Macs. Pet. App. A5, A22, A40-A41.

Petitioner invested $2,000 in the program. He claimed a $20,800 ordinary loss deduction with respect to that "investment" on his return for 1979, and reported a $21,961 net long-term capital gain on his return for 1981. The net gain of $1,881 before taxes was reduced to a net overall profit of $461 after the deduction of $1,420 in fees paid to GGS. Petitioner also participated in the tax shelter program in 1980 and 1981. The transactions were similar to those connected to his 1979 investment, except that he experienced slight net losses rather than gains in each year. Pet. App. A6, A38.

2. The Commissioner disallowed the loss deductions claimed by petitioner with respect to his participation in the tax shelter program, determining that the entire arrangement was an artifice having no economic effect other

than the purported creation of tax benefits.[3] Petitioner sought redetermination of the resulting deficiencies in the Tax Court, which upheld the Commissioner's determination in a unanimous, reviewed opinion (Pet. App. A13-A52). The Tax Court found that the transactions were "factual shams" (*id.* at A47), *i.e.*, that the "commodity trades" occurred only on paper in an artificial, self-contained market in which there was no bona fide prospect of economic gain (aside from tax benefits), nor any actual risk of economic loss (*id.* at A45-A47).

The court of appeals affirmed, holding that the Tax Court's conclusion that the transactions were factual shams was not clearly erroneous (Pet. App. A1-A12). The court rejected petitioner's claim that the Tax Court had applied the wrong legal standard to the sham inquiry, stating that the court correctly "reviewed the transactions for economic effects other than the creation of income tax losses, and in doing so considered both economic substance and business purpose" (*id.* at A8). The court then upheld the finding of a sham, concluding that petitioner "invested in a program designed to reap the tax benefits of real market investments without bearing the consequent risks" (*id.* at A11 (footnote omitted)).

3. Petitioner contends that the straddle transactions were not shams, but rather legitimate investments that could generate tax losses. This contention was correctly rejected by both courts below, and there is no reason for this Court to review their factbound determination.

Because of the complete control that GGS maintained over the forward contract transactions and the circular nature of the cycle of trades, it is apparent that petitioner

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[3] The Commissioner also eliminated the capital gain that petitioner had reported in connection with the subsequent cancellation of the other leg of the straddle.

did not have a genuine investment in Ginnie Maes and Freddie Macs; rather, he was a participant in a contrived "self-contained market operated and controlled by Mr. Gregory and his affiliates" (Pet. App. A10) that had no economic effect on the participants, but rather served only to generate tax losses. As the court of appeals found, "[t]he absolute power that [petitioner] conferred upon GGS to set contract prices and perform any act to alter existing contractual obligations, combined with the fact that no contract was ever enforced, entitled the tax court to infer that the entire program existed solely to provide tax benefits" (*ibid.* (footnote omitted)). Moreover, the "losses" taken on the client's tax returns had no real economic effect. They were simply debited to the client's account and carried on GGS's books without margin call or collection. The gain inherent in the remaining leg of the straddle was "locked in" and, when the rest of the contracts were cancelled, the gain was applied to the client's account to offset the debit generated by the earlier "loss." None of the contracts that GGS entered into on behalf of its clients ever resulted in the delivery of the underlying security. In these circumstances, the courts below plainly were correct in concluding that the transactions were devoid of economic substance and therefore a nullity for federal tax purposes. And that conclusion accords with the holdings of other circuits that have considered similar contrived commodity straddles. See *Forseth* v. *Commissioner*, 845 F.2d 746 (7th Cir. 1988); *Mahoney* v. *Commissioner*, 808 F.2d 1219 (6th Cir. 1987); *Wooldridge* v. *Commissioner*, 800 F.2d 266 (11th Cir. 1986) (Table).

Petitioner contends (Pet. 14-16) that the decision below conflicts with *Rice's Toyota World, Inc.* v. *Commissioner*, 752 F.2d 89 (4th Cir. 1985), and *United States* v. *Philatelic Leasing, Ltd.*, 794 F.2d 781 (2d Cir. 1986). Petitioner asserts that these decisions establish a two-part test under

which a transaction can be held to be a sham for tax purposes only if it is shown both that the taxpayer had no motivation for entering the transacton other than to obtain tax benefits and that the transaction had no economic substance. Because the court of appeals below declined to apply "a rigid two-step analysis" (Pet. App. A7), petitioner contends that it created a conflict in the circuits. This contention is without merit.

To the extent that the differences cited by petitioner in the formulation of the standard are more than semantical and could be significant in some factual situations (and we note that in both cases relied upon by petitioner the court of appeals agreed with the government that the transactions were shams), it is clear that they do not point to different results under the facts of this case. The Tax Court found that the transactions were "factual shams * * * designed * * * for the sole purpose of attempting to achieve tax losses for their investors" (Pet. App. A47 (footnote omitted)), and the court of appeals upheld that finding. Thus, the factual conclusion of the courts below was both that petitioner had no motive for entering the transactions other than to obtain tax benefits and that the transactions lacked economic substance; under any formulation, the transactions must be regarded as shams. Indeed, that this case would not have come out any differently under the "two-part test" cited by petitioner is manifested by the fact that the language on which petitioners rely has its source in a Tax Court opinion (see *Rice's Toyota World, Inc.* v. *Commissioner*, 752 F.2d 89, 91 (4th Cir. 1985), citing 81 T.C. 184, 209 (1983)), yet the Tax Court in this case—in a unanimous, reviewed opinion—found that the transactions were shams.[4]

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[4] Petitioner argues (Pet. 13) that the issue presented in this case is important because "Congress has enacted specific legislation to allow

It is therefore respectfully submitted that the petition for a writ of certiorari should be denied.

CHARLES FRIED
Solicitor General

AUGUST 1988

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straddle losses as deductions for income tax purposes" where the transactions are not shams. We note that the legislation to which petitioner refers, Section 108(a) of the Tax Reform Act of 1984, Pub. L. No. 98-369, 98 Stat. 630, was recently amended by Congress to reduce substantially the availability of deductions for straddle losses, Section 1808(d) of the Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2817. The Tax Court had held under the 1984 statute that straddle losses were allowable as long as it could be said that the transaction had a reasonable prospect of any profit, even if the primary motive for the straddle was to obtain tax losses. *Miller* v. *Commissioner*, 84 T.C. 827 (1985), rev'd, 836 F.2d 1274 (10th Cir. 1988). The Tax Court has now held in a unanimous, reviewed opinion that *Miller* should no longer be followed in light of the 1986 amendment and that straddle losses can be allowed only where the taxpayer demonstrates that he entered into the straddle transaction primarily for profit. *Boswell* v. *Commissioner*, 91 T.C. No. 15 (July 26, 1988).

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No. 87-2026

In the Supreme Court
of the United States

OCTOBER TERM, 1987

JAMES E. SOCHIN, *Petitioner*,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH JUDICIAL CIRCUIT

PETITIONER'S MEMORANDUM IN REPLY TO RESPONDENT'S OPPOSITION

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PETITIONER'S MEMORANDUM IN REPLY

1) This petition was filed because more and more frequently, as happened in this case, the Commissioner of Internal Revenue has been able to prevail upon some of the lower federal courts to avoid the application of hard statutory requirements by declaring, *ad hoc*, that a transaction was a "sham" and, thus, not entitled to further consideration under the nation's tax laws. The tax court and the court of appeals took that approach in this case, but, in similar situations the courts of appeals for both the second and fourth circuits have required a more discerning, and more objective, approach. *Compare* this case, *Sochin v. Commissioner*, 843 F.2d 351, 61 AFTR2d 926 (9th Cir. 1988), *with United States v. Philatelic Leasing, Ltd.*, 794 F.2d 781, 58 AFTR2d 5285 (2nd Cir. 1986), and *Rice's Toyota World, Inc. v. Commissioner*, 752 F.2d 89, 55 AFTR2d 580 (4th Cir. 1985).

In this court's *constitutional* jurisprudence, flexible balancing tests are often found to be appropriate in weighing or measuring evidence submitted at trial because of the inherently broad reach of constitutional provisions. Cases involving the Fifth Amendment and Fourteenth Amendment usually apply this method of adjudication. See, for example, *Tulsa Collection Services v. Pope*, 99 L.Ed2d 565, at 574-575 (1988).

By contrast, however, in matters of *statutory* interpretation, this court more frequently gives clear guidance to the lower courts by requiring the lower courts to measure trial evidence according to more precise and exacting standards. For example, in *Patrick v. Burget*, 100 L.Ed2d 83, 91-92 (1988) this court mandated a "rigorous two-part test" to measure evidence under a section of the federal anti-trust laws. That is the kind of rule petitioner is contending for here in this federal tax case.

The imposition of these tests is not mere semantics, as respondent suggests at page 6 of his memorandum, but is a reflection of this court's general requirement that litigants be treated fairly and that each litigant be given a chance to present evidence that will be measured according to a clearly stated standard, thus providing some assurance that similarly situated litigants, whether a citizen or a governmental entity, will be treated similarly. Recently this court reemphasized its "abiding rule that it treat all litigants equally: that is, that the claim of any litigant for the application of a rule to its case should not be influenced by the Court's view of the worthiness of the litigant in terms of extralegal criteria." *Patterson v. McLean Credit Union*, 99 L.Ed2d 879, 881 (1988).

Therefore, the approach of the Commissioner of Internal Revenue in this case and of the two courts below, as repeated in the respondent's memorandum, that the taxpayer, Mr. Sochin, tried to save a lot of tax and, therefore, should not have the benefit of an objective standard and of the rules enacted by Congress and the President, should be rejected.

2) Respondent also argues (memorandum pp. 6-7) that the result in this case will be no different even if the two-part test of *Rice's Toyota* were to be applied to the evidence of record. That is not true. The courts below found that, looking at the evidence as a whole, and not being required by any precise standard to examine *the taxpayer's* motives and the specific transactions *he* used, the whole program was a "sham." But that is the very point. The two-part test requested here by petitioner would require the courts below to change their focus on remand and to examine the taxpayer's *own* motives and purposes and the specifics of *his* trades. This would prohibit the lower courts on remand from doing what they did at first, brand Mr. Sochin as illegitimate and unworthy merely because *other* taxpayers may have treated the investment program as a sham.

3) Finally, the respondent argues at pages 6-7 (note 4) of his memorandum that the petition should be denied because the tax court has interpreted the underlying tax statute in this case (section 108 of Pub. L. 98-369, as amended) as requiring a primary profit motive. It is not clear just why the petition should be denied on that ground. In any event, the respondent failed to mention that the rule in the ninth circuit (which controls this case) is different: under section 108 the investment must have a reasonable prospect of profit, not necessarily a primary profit motive, in order to permit deduction of transaction losses. See *Wehrly v. United States*, 808 F.2d 1311, 58 AFTR2d 5260 (9th Cir. 1986).

4) In conclusion, the lower federal courts, including the tax court, are in disarray as to what standard to apply to the trial evidence to determine whether statutory rules can be avoided when the Commissioner of Internal Revenue comes into court contending that a transaction is a "sham." As detailed in our petition, this case presents an ideal vehicle for this court to provide direction on that point by extending its holdings in *Frank Lyon and Company v. United States*, 435 U.S. 561, 55 L.Ed2d 550, 98 S. Ct. 1291, 41 AFTR2d 1142 (1978) and *Commissioner v. Bollinger*, 485 U.S. ___, 99 L.Ed2d 357, 108 S. Ct. 1173, 61 AFTR2d 793 (1988), to the class of case (speculative investment) presented by this record.

We therefore respectfully request that the petition be granted.

AUG 22 1988
Date

/S/ JOSEPH WETZEL

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CERTIFICATE OF SERVICE

Pursuant to Rules 28.3 and 28.4 of the Rules of the Supreme Court of the United States, this certifies that three copies of the foregoing petitioner's memorandum in reply to respondent's opposition were served on:

Mr. Charles Fried
United States Solicitor General
Department of Justice
Washington, D.C. 20530

All parties required to be served have been served. All service was done by mail with postage prepaid on August 22, 1988.

AUG 22 1988 /S/ JOSEPH WETZEL

Date

Joseph Wetzel
Counsel for petitioner